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Our New Format

This is the first issue of *Business Topics* as a quarterly rather than a bi-monthly as it has been since its publication began in 1953.

Formerly, *Topics* carried both articles of lasting interest and "news" about current economic conditions in Michigan. This dual nature posed certain problems. More frequent reporting was needed for those who wanted to keep up with the state economic scene, while frequency of publication was of minor importance to those who were primarily interested in articles not so closely tied to current events.

In order to solve this dilemma, the decision was made to remove current economic analysis from *Topics,* to publish such material in a monthly leaflet to be called *Michigan Economic Record,* and to change *Topics* into a quarterly of somewhat larger format.

The first issue of *Michigan Economic Record* was published in January, 1959, and subsequent issues will come out each month of the year except August. *Topics* readers who would like to receive the *Record* also will be put on its mailing list upon request.

It is hoped that these publication changes will be of value to our readers and will be in keeping with the Michigan State University tradition of rendering the greatest possible public service.

E.P.C.

VERGIL D. REED

The Role of the Advertising Agency:

Is It Changing?

It seems to me that I have used an inordinate portion of my limited time on earth explaining how I make my living and what an advertising agency is. In this paper I would like to examine the agency's role, to determine what the concept of its duties have been in the past, and how and to what extent its services have changed up to now or seem likely to change in the foreseeable future.

In 1841 Volney Palmer "organized a newspaper advertising and subscription agency." By taking out three words—*newspaper, and, subscription*—we evidently staked our claim to a name that means many things to many people. This first "advertising agency" did not buy or sell advertising. It did not plan, prepare or place advertising. Palmer tried to operate as the exclusive agent of certain newspapers for a commission of 25% paid by the publishers on white space he sold to advertisers. He had plenty of competition in a hurry from other agents—and from direct sale of space by the newspapers. The exclusive idea faded quickly.

Up to about 1865 the so-called advertising agencies were merely brokers or dealers in white space. Some few gave a bit of help in placing the advertising but no other services were offered. They did not convert publishers' white space into clients' advertising. Then in 1865 a new type of agent appeared. George Rowell contracted with about 100 newspapers (mostly New England country weeklies) for a year. Rowell "retailed" this column in one-inch units at a generous profit. His slogan was "An Inch of Space a Month in One Hundred Papers for One Hundred Dollars." That was a big scale business for the time, too.

In 1878 J. Walter Thompson came out with his exclusive "List of Thirty" magazines, and this new medium developed rapidly.

The period between 1865 and about 1880 was predominantly the wholesaler or general agent era. The agent bought space in bulk at as low a cost as possible and "retailed" it to advertisers at as high a price as possible. About 1875 the special agent appeared on the scene. These special agents solicited advertising for one or a very few strong newspapers. They later became what we now know as newspaper representatives, but for years their competition made life miserable for the general agent.

DR. REED *is a former Vice President of the J. Walter Thompson Company; he is now Professor of Business Administration, MSU.*

About 1880 the *service agency* began to evolve, and developed rapidly during the next twenty years. Up to the emergence of the service agency, only poetic license and convenience could justify the use of the term *advertising agency.* Agencies did not even write copy and had not recognized that as an agency function.

By about 1900 the service agency was much in evidence. It offered expert and specialized service in both planning and executing the advertising program. Its service had reached the professional stage. Creative activities were stressed. The role of the agency had become that of increasing the effectiveness of the client's advertising — making advertising pay the advertiser. The agency had become an *advertising agency.* From now on it would convert publishers' white space—and later, radio and TV blank time—into clients' advertising.

In 1901 came the Curtis Publishing Company contract, soon followed by similar contracts with most other publications, which definitely established the present firm card rate and commission system, later accepted by the new media, radio and television. With advertising widely accepted, the advertising agency donning the long pants of maturity, the automobile just arrived and William Jennings Bryan on stage, we raise the curtain on the century and on the role of the advertising agency in our economy.

GROWTH AND CHANGE

When the century opened our population was on the brink of 76,000,000 and our factories employed 6,090,000 people. We were still in the extractive industry stage. Our level of living was pathetically low by today's standards.

In less than 60 years our population has more than doubled. Our factories employ more than two-and-a-half times as many people. We have matured to the stage of industrial development wherein a quarter of our total employed persons are in manufacturing. The level of living we have attained is the envy of the world, and it continues to rise.

In 1900 we produced 4,192 automobiles. That isn't even a good two hours' work for our automobile industry today. Those early automobiles were useless rich men's toys and conversation pieces. The role of the automobile has changed from that of a conspicuous consumption bauble to an everyday necessity.

In 58 years we have moved from a farm-forest-and-mine economy through a production-oriented industrial age of relative scarcity to a consumer-oriented dynamic economy of plenty.

New Jobs for Advertising

In the 1880's there were perhaps a dozen firms outside the patent medicine field that did any consistent and planned advertising. By 1900, however, most everybody was well acquainted with such names as Kodak, Heinz, Prudential, Beeman's, Coca-Cola, Uneeda, Quaker Oats, Woodbury, Postum, 1847 Rogers Bros. and Cream of Wheat. The age of mass production was on the threshold and already becoming more and more dependent upon mass distribution and mass consumption, though few yet realized it. This meant rapid expansion of advertising. Even its role and functions were changing. From signs and small space "card" announcement and reminder advertising to a greater and greater selling job was a natural evolution. But new jobs for advertising were being discovered too.

The popular assumption was that advertising had but one role—that of increasing the sale of goods. It was soon discovered that advertising could sell ideas as well as goods. It had educational values. In 1908 the first large-scale continuous public education program was launched by the American Telephone & Telegraph Company. At about the same time cooperative advertising was first used—prunes in 1901 and oranges (Sunkist) in 1907.

With these changes since 1900 came changes in the role of advertising as well as automobiles, striking changes in our whole way of life—but little change in the role of the advertising agency. We have heard much and read much of "the modern concept of marketing," "new concepts in marketing," "the changing role of the advertising agency in today's marketing management" and "the new role of the advertising agency." But, accepting the fact that the real advertising agency — the full service agency — arrived with the present century, has its role changed since that time?

THE SERVICE OF THE AGENCY

In the early 1900's the role of the agency had evolved to a very simple and clear one of doing everything possible *to increase the effectiveness of the client's advertising*. The American Association of Advertising Agencies was formed in 1917. In 1918 a Report on Agency Service submitted by a national committee sponsored by the Association was approved. Said the report, "Agency Service consists of interpreting to the public, or to that part of it which it is desired to reach, the advantages of a product or service." The section on Agency Service states:

Interpreting to the public the advantages of a product or service is based upon:

1. A study of the product or service in order to determine the advantages and disadvantages inherent in the product itself, and in its relation to competition.
2. An analysis of the present and potential market for which the product or service is adapted:
   As to location
   As to the extent of possible sale
   As to season
   As to trade and economic conditions
   As to nature and amount of competition.
3. A knowledge of the factors of distribution and sales and their methods of operation.
4. A knowledge of all available media and means which can profitably be used to carry the interpretation of the product or service to consumer, wholesaler, dealer, contractor or other factor.
   This knowledge covers:
   Character
   Influence
   Circulation .... Quantity, Quality, Location
   Physical Requirements
   Costs

   Acting on the study, analysis and knowledge as explained in the preceding paragraphs, recommendations are made and the following procedure ensues:
5. Formulation of a definite plan.
6. Execution of this plan:
   (a) Writing, designing, illustrating of advertisements, or other appropriate forms of the message.
   (b) Contracting for the space or other means of advertising.
   (c) The proper incorporation of the message in mechanical form and forwarding it with proper instructions for the fulfillment of the contract.
   (d) Checking and verifying of insertions, display or other means used.
   (e) The auditing, billing and paying for the service, space and preparation.
7. Cooperation with the sales work, to insure the greatest effect from advertising.

The agencies worthy of the name were already willing to do anything they could to make their advertising more effective. This had for many years in-

cluded participation with the client at policy and planning levels. These regular "summit" contacts between client and agency were very common but varied with personalities and types of organization, just as they still do today. More people are involved in these contacts today for the very simple reason that the scale of the operations is greater and specialization involves more people. Market research and copy research were already being carried out, though often under other names, for even the term marketing was not too widely known until the early 1920's. Split-run copy testing was done in *The Red Book* as early as 1914 and 1915. J. Walter Thompson Company brought out its first edition of its internationally known *Population and Its Distribution* in 1912 and has continuously operated a Marketing Research Department since 1916. Agencies were already helping clients design packages, name products, check up on distribution methods and do better merchandising jobs. Harry Dwight Smith began in 1908 to stress the need for an internal situation survey and a market survey for the client before advertising was undertaken. Agency executives were already urging clients to integrate their advertising into well-conceived marketing plans. Unfortunately for him, most of these functions still fell largely or entirely upon the account representative's shoulders in most agencies.

Motivation Research

I sometimes wonder, even in advertising, if "the new is but the old come true" or if we forget and pour old wine into new bottles. Thirty-nine years ago I was working with Dr. Harry D. Kitson (author of "The Mind of the Buyer") on motivation research. This included studying the correlation of the salesman's height and his sales volume, and the reasons for it. We were using, and found wanting, ink blot tests even before I knew Rorschach had anything to do with them. Then there appeared upon our continent a supposedly great new marvel four or five years ago, known as motivation research. Unfortunately it became a fad, with many of the abuses that go with fads, but real motivation research simply isn't new to advertising agencies.

Marketing Research

Thirty-two years ago I was with what was at that time the largest industrial advertising agency as Director of the Research and Service Department. We were deeply involved in marketing and merchandising, reaching through the industrial market on down to the household consumers of end products. In fact, under the company name appeared "Advertising and Merchandising." We were doing much detailed marketing research on such products as lifting jacks, steel fabric, junior steel beams, stainless steel, and plumbing fixtures. We were stressing the necessity of integrating advertising into a well-rounded marketing plan which involved the proper meshing of: the company and the industry; the product; the market; distribution; and advertising. Out of this experience came my book, *Planned Marketing.* In that book of thirty years ago the role and functions of the advertising agency were described as follows:

The modern advertising agency has gradually evolved as a result of the well-founded principle of specialization— an admission that one man cannot possess all advertising knowledge and that a well-rounded, complete and efficient advertising service is dependent upon a high

degree of teamwork among specialists in the various fields of advertising technique — research, merchandising, media, copy, art and related fields. The agency is a composite personality made up of organized talent and experience assembled in a form which permits the effective and consistent application of the best known advertising and merchandising principles . . . Today the better agencies have developed organizations capable of directing all the marketing and merchandising operations of the manufacturer or service institution in an economic and effective manner, based upon experience with hundreds of products and many industries.

AN UNCHANGING SERVICE

In a speech before the American Association of Advertising Agencies in 1927, under the title "Where Is the Advertising Agency Going in the Future?" Eugene McGuckin said, "There are tremendous tasks to be undertaken — all looking toward increasing of the power and efficiency of advertising." He had no new role to suggest—merely playing the old role better.

Looking backward from 1928, agency service as described in the 1918 report of the American Association of Advertising Agencies still remained unchanged. One new medium, radio, had come on the advertising stage in the 1920's but involved no change in the role of the agency, except for those who tried building their own shows—for a while. By 1930 the role of the advertising agency had really changed only in one notable respect since 1900. The old practice on the part of some agencies of financing or helping to finance the client's advertising or launching a new product was a thing of the past, though some very well known products were "put over" by this form of financing. *To increase the effectiveness of the client's advertising* was still the role of the agency in 1930.

Depression

Beginning with 1930, advertising went through the wringer along with the rest of our economy. Our retail sales fell almost 50% between 1929 and 1933 (from $49.1 billion to $25.6 billion). The total volume of advertising in the U. S. fell over 60% (from $3.4 billion to $1.3 billion) over the same period. That 1929 advertising volume was not reached again until 1947. The depression years saw urgent demands for quick results and greater efficiency of advertising in spite of the drastically reduced appropriations. Unfortunately immediate sales were usually given preference over gaining long-term consumer acceptance and preference. Premiums, contests and deals went rampant.

Costly Lessons

The world-wide collapse of the flimsy post-war inflation boom swept aside all trace of balance between production and consumption. It left no doubts that the future of our economy lay in our ability to create and maintain a dynamic market and a distribution system capable of absorbing the output of our mass-production industrial facilities. The full realization of the role of the consumer in a dynamic economy began to dawn upon us. It was a costly period of economic education to equally chastened agencies and clients. It became painfully obvious that a major role of advertising in a dynamic economy is to deliver a fair share of the benefits of mass production and mass distribution to consumers along with the goods they buy. But the Great Depression did not change the role of the agency. It was still to increase the effectiveness of the client's advertising, — but more and faster.

New Media

Out of the depression came the birth and lusty growth of the supermarket along with other forms of self-service and mass retailing, all increasingly dependent upon pre-selling the consumer before he goes to the retail counter. The brands that moved fastest soon were getting the choice shelf space in the supermarket, department store, variety store and drug store. The three or four brands which scored the highest consumer preference, or insistence, began to get the shelf space of the mass retailers—or at least the best shelf space next to the retailer's private brand. This brand competition for shelf room or rack space based on consumer preference or insistence had by the early 1950's become a major force in marketing. Today, when your product is pulled off the shelf, "You've had it."

Although radio came in as a new medium in the late 1920's, its real growth came after 1930. Commercial motion pictures developed rapidly into a mass medium after 1932. Television was demonstrated publicly in 1927, but it did not really attain importance as a mass advertising medium until the late 1940's. By that time—and in much less than a century for all practical purposes—advertising had become the greatest single means of mass communication. The advertising agency occupied a key position in this system of mass communication but its role was still the same. It merely had more media, more specialists, better research and improved methods with which to carry out its role of *increasing the effectiveness of its client's advertising.*

The decade of the 1940's had barely made its entry when war spread over the world. The United States was fortunately free of devastation. In spite of our war efforts our production facilities had reached the stage that permitted us to have both guns and butter in plenty. In fact, our level of living actually continued to rise in spite of mild shortages and controls for a few items. Normal marketing and advertising operations were of course considerably upset temporarily.

Public Service and Long-Range Planning

Advertising appropriations did not shrink as much as expected during the war, for three reasons. First, most advertisers had come to appreciate the fact that advertising was a long-range force and investment, and that continuity was necessary to success in gaining leadership or maintaining a position in the market. Second, Federal tax laws allowed liberal advertising expenditures to be deducted as a business cost. Third, advertisers, media and agencies did a generous amount of public-service advertising during the war period. Some of this was paid for in whole or in part by the Government agencies for which it was done. Most of it was planned, created, placed and paid for cooperatively by advertisers, agencies and media. The Advertising Council was particularly active in encouraging this public-service advertising during and since the war. This type of advertising in no way changed the role of the agency.

There was widespread concern that our production facilities had been overexpanded and that their output could not be sold and consumed. Except for our farm surpluses, however, that fear was an unfounded one. During the period of reconversion from war to peace the number of unemployed reached a

maximum of 2,700,000. Our economy remained in high gear and a period of expansion began which astounded some of the optimists and embarrassed the pessimists.

We finlly reached and surpassed our 1929 total advertising volume in 1947. Then growth was constant and extremely rapid. The total increased almost two-and-a-half times, from $4.3 billion in 1947 to $10.4 billion in 1957. The expected volume for 1958 is $11.0 billion.

A DYNAMIC ECONOMY

This constant expansion of advertising volume is the outgrowth of a very dynamic economy, of course, but it is also partly due to a better understanding of the functions and necessity of advertising in keeping that economy dynamic. Ours is now a consumer-centered economy of plenty, conceived in ambition, mothered by the machine, and sired by power. The continued growth and dynamism rests, not upon the satisfaction of present wants alone, but upon the continuing stimulation of new ones. In an economy of abundance, our production facilities can supply goods faster than our population learns to want these goods or to consider them necessities. To remedy that situation is the role of advertising.

Naturally, with the growth of the economy, the increasing dependence of that economy on advertising, and the rapidly growing volume of advertising, the advertising agencies, too, grew at a disconcerting rate and still continue to grow. Jobs, specialists and titles, but not functions, multiplied and proliferated. Such titles as Director of Market Potential, Merchandising Executive, Marketing Vice President, Manager of Marketing Development, Coordinator of Marketing-Merchandising and Research Representative do not represent any addition of new functions or a change in role. They merely represent further division of labor and specialization in the performance of old functions, in keeping with the increased scale of accounts, business organization, markets, media, and appropriations.

New Methods

We must not confuse size, specialization, new mass media and new methods with role or function. The agency's sole interest in marketing should be to achieve greater effectiveness in advertising, not to add a new function or enter a new field. Better integration of advertising into the marketing plan should be the aim. Sound agency counsel in these related fields is essential to maximum effectiveness in advertising, but let's not get our bailiwicks mixed. The advertising agency cannot and should not attempt to take over the marketing function of the client. That would indeed be a new role for the advertising agency. Even changing the name of the advertising agency to marketing agency, as suggested by some, would not in reality change the role of the agency but merely the name.

Old Functions

The role and functions of the advertising agency have changed remarkably little since about 1900. Methods are more refined. Services are more professionalized and will continue in that direction. Perhaps some of us will even live to see the time when the agency will have reached such a professional status that it will not even solicit new business. Methods of operation have changed. They will continue to change. There

will be further specialization, more mechanization and possibly a new medium or two. The dominant role of the consumer in today's dynamic economy has set a much better stage upon which our role can be played more effectively. I think we understand that role and the responsibilities that go with it better. The role itself is an unchanging one of increasing the effectiveness of the client's advertising, through better use of our present and future mass communication system.

And for final evidence that the role of the advertising agency is not a changing one, one can compare the Agency Service Standards of the American Association of Advertising Agencies, revised as of February 15, 1956, with those same standards set forth in 1918 and quoted earlier in this paper. There is a difference of just four words in item number 6, "Execution of This Plan," and those four words make no significant change.

If I could only be certain of being here to collect, I'd be willing to wager that the role of the advertising agency in 2000 A.D. will still be *increasing the effectiveness of the client's advertising.*

The mediocrity of salesmanship is only a part of our national pattern of always being willing to settle for something less than the best. For this, in America, is the high tide of mediocrity, the great era of the goof-off, the age of the half-done job. The land from coast to coast has been enjoying a stampede away from responsibility. It is populated with laundry men who won't iron shirts, with waiters who won't serve, with carpenters who will come around someday maybe, with executives whose mind is on the golf course, with teachers who demand a single salary schedule so that achievement cannot be rewarded, nor poor work punished, with students who take cinch courses because the hard ones make them think, with spiritual delinquents of all kinds who have been triumphantly determined to enjoy what was known until the present crisis as "the new leisure". And the salesman who won't sell is only a part of this over-all mess.

Charles H. Brower

Reprinted from "Let's Go, Reflections on the Art of Administrative Leadership."

ANDREW HEISKELL

The Role of Marketing Research

in today's business management

I am pleased to receive this impressive award for the "LIFE Study of Consumer Expenditures" and the "LIFE Roundtables on Marketing." I think it is obvious that I do no more than accept these awards in the name of the many people who have contributed to this progress in the science of marketing. It is my role as publisher to foster an environment in which the bright, creative and analytical people in research, both within our company and in the professional research firms we employ, can flourish and produce new and useful ideas and research in response to the marketing challenges we face individually and as a nation.

The reason I am particularly gratified by this award is that it comes as a symbol of recognition and achievement from thoughtful leaders in marketing in this great university. At LIFE our research is of necessity oriented towards very practical business considerations and problems. When in the course of this practical work, we can develop something which is of sufficient breadth of interest to merit your attention and approval, then I think we can feel that we have made a significant contribution to the art and science of marketing.

CONSUMER EXPENDITURES

If I may, I'd like to sketch briefly the history of the Study which is the basis for this distinguished award. Our research department first suggested a study of consumer expenditures in 1954. Their suggestion came as a result of considerable needling on my part for a study that would significantly contribute to our knowledge of marketing and truly serve the marketing needs of our customers. This heckling, combined with the real scarcity in basic marketing data which they themselves experienced, resulted in this study. It hardly seems possible, but I was told in 1954 that basic studies covering the full range of consumer expenditures then in use dated back to 1936 for some purposes, and to 1939 or 1940 for others. There

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MR. HEISKELL *is publisher of LIFE. This article is based on his address at East Lansing, October 15, 1958, upon accepting MSU's 1958 Marketing Award. It is also available from the Bureau in the form of Marketing and Transportation Paper No. 1.*

were no more recent broad-gauge national studies available for use. The 1950 Bureau of Labor Statistics Study was completed, but basic tabulations were not available because of economy moves in the federal budget. It seems to me that this is a shocking indication of the great need American business has for current and basic marketing background data.

While individual companies undoubtedly do a great deal of research on markets and consumers, there is very little available for the serious student of consumer expenditure patterns in a broader sense. When we consider the investments made in research for technological development in contrast with the investments for research into consumer behavior and consumer expenditures, we can understand why there are such limited data available for study. One significant need for the future development of marketing as a science is respectable budgets for research.

This all makes undertaking a study of consumer expenditures a very simple and logical thing to do. It is, in retrospect, but it was anything but simple at the time. It was difficult to believe that there was the paucity of marketing data which my research people described to me. It was hard to understand the great amount of experimental work which had to be done before a study of consumer expenditures could be undertaken. Finally, I'm accustomed to dealing with some fairly large numbers but I was never more staggered than when I heard the cost estimates for this study.

A lot of facts have gone under the bridge since then. We did get through the experimental work. We somehow adjusted to the budget necessary to do the study (I believe it is the most expensive study ever undertaken by private industry.) We have been using the results for over a year now and I truly believe that the study has made a significant contribution to business. We find there is tremendous interest in the figures, both from businessmen and from academic people as well.

While we have more figures or numbers than you can shake an electronic tabulating machine at (they tell me that we have some 2 million IBM punch cards floating through machines), I am reminded of a remark made by Prof. Neil Borden of Harvard when we had our first roundtable on the subject of marketing and consumer expenditures. He said: "The only way you are going to get any meaning out of these figures is by sweating over them." He was exactly right. There has since been a lot of perspiration applied to these figures, and some of the more significant meanings have been developed and will continue to be mined out of our mass of data.

MARKETING ROUNDTABLES

This brings me to the second basis for your award, the marketing roundtables. These were developed as a consequence of the study to provide us a means for discussing both the study and basic marketing problems with important businessmen and academic leaders. From our point of view these meetings have been most rewarding. We have had outstanding people from academic life like Peter Drucker and Steuart Britt chairing our sessions. We have had well-known business executives, marketing people, economists, and sociologists in attendance. Your school was represented by Tom Staudt at the ses-

sion we had in Detroit. We all derived a great deal from these sessions. We have gained an understanding of the basic problems of marketing in our economy. We have had pointed out to us some of the more fruitful areas for future research. We have shared with businessmen their long-range concerns about marketing. One of the more useful by-products has been the contact which has been established between the professors and the businessmen. It was most refreshing to have both groups sitting down together to think in broad philosophical terms about marketing in our economy. In a sense we provided a forum where the thinkers and the doers or practitioners could find a happy meeting ground. While I'm aware of the great amount of consulting work which marketing professors do with industry, these consultations all too often tend to focus on narrow and specific industrial problems.

Of course, the basic value of these roundtables to businessmen derives from the variety of backgrounds offered by the participants and the intimacy of the setting. In each of these groups of 25 or 30, manufacturers and retailers sit down together with those from academic life and the world of communications. There is a freedom of personal exchange, an exposure to both the theoretical and the practical which all have found stimulating. And one of the other highlights, of course, has been the excitement of fresh contributions of thought on national marketing problems outside the usual familiar names and companies. Our plan is to continue these roundtable meetings in various parts of the country to develop further some of the broader marketing concepts for the benefit of us all.

THE ROLE OF MARKET RESEARCH

So much for the specific studies. As a publisher I'm also a businessman. Over the years I have spent in excess of $15 million for research. This is research to guide the advertiser in his evaluation of media and research to guide me in making decisions for the publishing of LIFE. This rather substantial expenditure perhaps gives me the right to make a few observations on the role of market research in today's business management.

First and foremost, I am impressed by the urgent need for businessmen to seek to understand the values and complexities of market research. All of us should work hard to share our experience in marketing with others. All around us one sees the pitfalls of failure to comprehend the role of research in good management.

Some companies have been ruined by the speed of changes in the market place. I have the impression that many business heads, in candor, will freely admit their very great uncertainty on where to lead their companies.

I know one large company that has been almost totally liquidated and is now searching for a place to invest the stockholders' money. I know another with sales in the billions which is asking itself what it should do with the business. I know a third, also a great name on the American business scene and with sales in the hundreds of millions, which seems to be up against an inevitable downward trend, and which is searching frantically for ways to maintain its competitive position. I see ads regularly in the Wall Street Journal—companies (some desperately) seeking other means of diversification for working themselves out of a box.

I know a so-called "business raider" who says the failure of companies to evaluate their markets and to know when to change is what has made him rich. He says the stockholder is entitled to a management which will invest company funds in whatever way will save and make productive the stockholder's investment. Frequently radical action is called for. Certainly it must be preceded by knowledge of markets and careful research.

Cases like these are frequent in today's business world. Common to them all is the obvious relationship between the kind and amount of research and the company's continued success.

Given an urgent need for research, the question becomes: what kind and how much? I would like to illustrate. Perhaps a good way to start is with a story I heard recently, of a youngster who was spending her first night away from home, at her grandmother's. Grandmother tucked her in, but about an hour later the child was up crying hysterically. Grandmother tried to calm her down and finally discovered she was afraid of the dark. The grandmother said: "Now isn't that silly? A big girl like you afraid of the dark. Why it's just as dark at your home, isn't it?" To which the child replied: "Yes, but that's different. That's my dark."

In a sense, each of us has had some area of darkness in relation to marketing and market research. It seems to me that one of the most common misconceptions is reflected by Jack Webb of Dragnet fame, who "wants just the facts, ma'am." There is a very strong tendency to think of research men as fact finders. They are supposed to produce the facts which will, in effect, lead the executive to the simple and unalterable business decision.

Actually, nothing is more deadly than reams of cold statistics about yesterday's marketing conditions unless it's yesterday's newspaper. The old saw of "let the facts speak for themselves" has had a most destructive effect on research. The plain truth is that figures do not speak for themselves. The data collected by research must be interpreted in terms of their applicability to the various alternatives confronting management. The facts must be organized and analyzed in the light of their significance within a specific context and in regard to a specific decision.

Management today, due to improper or insufficient understanding of research, to sheer laziness, or to the wish to evade responsibility in making decisions, far too often wants marketing research data only at the end of the line —where the data lead to the relatively simple, inescapable conclusion. This is decidedly not a sound approach to the solution of management problems.

Decision Making

From all sides today we hear that "the tycoon is dead—and good riddance too." But just as in so many other things, here too we would do well to reexamine the tycoon and the elements of his genius before we send him hurtling down the wastechute. There were many facets to tycooning—and some of them we could do well to have on the side of management today. Current decision making is so diffused, so decentralized, so de-everything, that business leadership cries out for some solid tycoonmanship. In the use of market research we need a manager who, like the barons of the past, orders the job done in a cre-

ative image, analyzes the findings and says "these are my evaluations and here is what we must do about them." This is a far cry from today's so-called executive who lets the figures come to him, with a minimum of interest or sponsorship in the process and then throws them away, either figuratively or literally. He wants safety in his research figures, not the beginnings of new enterprise.

Of course, the greatest hallmark of ignorance and ineptitude today is the remark "you can prove anything with research—or figures." None of our staff can evade the responsibility of evaluating and expressing an opinion on the quality or pertinence of research with such a glib comment. I would recommend this attitude to other business managers.

What is the Problem?

The way I see the relationship between research and management working effectively is to have management actively involved and participating in determining what the problem is and in developing what knowledge is sought for what purpose.

For example, management should never assign to research a problem as broad and as vague as "How can I get a bigger share of the market at a larger profit?" That problem probably sounds familiar to some of you researchers.

This process of mutual cooperation in the beginning stages of research will, of course, enhance the likelihood that the researcher is focusing on the right problem. It will also be more likely that the problem being researched is one on which management can act when the research is assimilated. Finally, if management becomes intimately involved in the development of the concepts to be researched, it will minimize the extent to which management will be guilty of the kind of myopia which assumes that there is always just one factor or one cause that produces a given marketing phenomenon. The fact is, most often marketing problems do not have their roots in a simple single cause or factor, but in a complex inter-relationship of a substantial number of factors. Research can usually shed a great deal of light on the various alternatives with which the executive is confronted, but the problem is often so complex that the decision is still a matter of good judgment on the part of the executive. Good research will increase the likelihood of a sound decision by contributing information about the various alternatives, but in most cases it does not replace the judgment or the experience of the effective executive.

Design and Prediction

As a matter of fact, in many cases a scientific research approach to a business problem often makes actual measurement unnecessary. Researchers today, better trained than formerly in disciplines based on rigorous scientific methods, use what they call "experimental design". This is nothing more than a concrete formulation of the problem and the research steps which might be taken to solve it. In going through this often painful exercise in logic, the nature of the problem itself is often clarified. And, at times, the restatement of the problem has made it clear that actual field measurement was unnecessary.

Virtually every important management decision also involves a prediction of the future. Often the actual forecast is simply implicit in the decision, but the fact remains that there is no choice

between forecasting and not forecasting. Hence, research, to be useful, has to assume some burden of prediction. In this connection, research can never, of course, offer the perfect prediction and therefore absolve management of the necessity for decision. Rather, research generally makes its chief contribution by simply narrowing the area of uncertainty.

So far, I've been emphasizing the responsibilities of management to research. However, I think there are some equally important areas in which the researcher has been somewhat remiss in his responsibility to management.

Defining the Limitations

All too often, research people do not adequately or clearly communicate to management the limitations of research. I have been more than slightly befuddled by the researchers when they try to explain the accuracy of a given number or percentage in a study. This gets even more complex when comparing two numbers or percentages derived from two different studies. I am certain there is adequate scientific reason for their words of caution, but in the absence of understanding there is a strong temptation just to accept the numbers and to ignore the complex imponderables which research people toss out in their inimitable jargon.

Researchers tend to fall in love with the fascination of being able to make good measurements and creating imaginative techniques for making these measurements. They tend to emphasize the research development and technique phase to the degree that you wonder if they remember the purpose or objective of the research or whether this simply provides a challenge which enables them to flex their technical muscles. In other words, I am primarily concerned with the problem-solving ability of research and only secondarily with the means by which this is to be accomplished.

It is equally as important for management to know when not to use research as to know when to use it. To repeat, research has to be applicable to decision-making. This means that research must attempt to measure the effects of what business has control over. For example, any examination of the motives of consumers—why they do or do not buy—should always emphasize those motivational factors that management can influence, such as price, manner of presentation of the offer, package design, distribution, etc.

A few weeks ago, Vice President Nixon, in commenting on public reaction to the policy of the United States in the Far East, said that he "would not tolerate government by public opinion polls." This also raises the interesting question of whether we should have business by public opinion polls or market research.

CREATION OF FUTURE WANTS

There is a commonly-held belief that it is the chief function of market research to discover what the consumer wants and thereby pave the way to giving it to him. But there are obvious limitations to this concept. Tomorrow's market place is certain to be crowded with products and services which today's consumer hasn't the slightest ability to identify or describe now. Yet the gropings and strivings of today's schoolchild or seventy-year-old do offer clues which, when interpreted and acted upon with clairvoyance and technical skill, can become the multi-billion dollar industries of tomorrow. We can't expect

the consumer to indicate products he may want in the future. Through research the consumer may tell us of his needs and wants. These should then provide the fuel to start the creative minds devising the products the public will be wanting when the manufacturer puts them in its hands. Consumer opinion and attitudes and consumer behavior are the raw materials from which intelligent management can forge marketing success.

I was amused to read a generalization which one researcher distilled out of years of study of the consumer. He concluded that anything which contributes to human laziness is bound to be successful.

Here at LIFE we face this problem in the sense that it would be a strong temptation to conduct public opinion polls to measure the consumers' reaction to the editorial content of LIFE Magazine. We do no research in this area because we do not feel the public can tell us what it wants to see in the future. Editorial opinion research, by stressing what was liked or disliked, is all too apt to create a deadly mold within which the editor will operate.

What about the future of research? I'm hardly the one to talk about the future of research. However, the turtle never makes any progress until it sticks its neck out, so I will do the same.

I think there will be a breakthrough in research in the next few years. This breakthrough will come as a result of bringing to bear a number of different scientific disciplines on the problems of marketing. A significant start has been made in this direction by the application of the methods of operations research to the problems of marketing. This inter-disciplinary approach offers great promise for the future.

I believe there are a few conditions which must be met before this research revolution takes place. First of all, management must adjust itself to marketing research expenditures that are more in line with research and development expenditures than in the past. However, it is not just a matter of spending money. I believe a second inhibiting factor is the difficulty in communications which exists between operations research men and the kinds of people that now constitute management of many large companies. This question may be resolved by better communication on the part of operations research or a new breed of management that is competent to cope with the complexities and demands of these new scientific approaches which require a substantially new and different scientific training and background.

Thirdly, I think we should never forget the fact that in all of our research we are in a sense dealing with the human soul. The dynamic qualities of the individual in his opinions and in his behavior are not simple unidimensional phenomena that can be easily explained or explored. So, perhaps, in all our research we must recognize an unknown quantity in the unresearchable qualities of the people who ultimately constitute our markets.

The Dynamic Market

Aside from the dynamic quality of the consumer as a personality we must remember that markets also are dynamic. Our society—perhaps more than any other—is capable of changes and mobility that cannot be paralleled anywhere else in the world. Where else in the world can the hoop become an over-

night innovation that finds its way into 15 million homes? This ability of the American consumer to act individually and marketwise in both predictable and unpredictable fashion is a challenge to the researcher and one of the fascinating enigmas of our time.

The Moral Environment

Finally, related to the essential humanity of research, is the need to relate it to an essentially moral environment in business. The best research in dishonest hands is *ipso facto* dishonest and deals the cause of both research and business a terrible blow. Call ours a Christian capitalism if you will. Certainly as businessmen we must relate our work to a moral environment. And by so doing, I am convinced, we will serve both our system and ourselves the better. With greatness of spirit, both minds and markets grow.

OUR EXPANDING ECONOMY

Market research in the future will play an ever more important role. In a basic sense our industrial technology has far outrun our marketing technology. We must now develop our ability to distribute and consume goods rather than our ability to produce more. To the extent that the American society needs a bit of prodding we have to induce an ever-increasing standard of living.

Most importantly, market research will have to assist the manufacturer in determining the qualitative factor which, I believe, will to a great extent determine tomorrow's markets. In a sense this country has achieved an economy of abundance. There probably isn't very much sense in doubling the production of spinach. On the other hand, there is likely to be a great shift to quality goods, quality interests, quality entertainment. The indicators exist today when you see a company putting out gourmet foods or a supermarket selling orchids. Will market research help in delineating this trend?

The stakes for which we are playing are high. They go beyond the normal cycles of business prosperity and recession and depression. Today more than ever before a healthy economy is living proof of the fact that our way of life and our form of government really work. Continuing prosperity and a productive economy are essential to the future of democracy. The intelligent communications between consumer and producer which research represents are essential ingredients of an expanding economy.

ANDREW F. BRIMMER

Pension Fund Trustees and Corporate Control

Since these trustees could sway the policies of companies whose stocks they own, what safeguards against uncontrolled use of this power exist or are in prospect?

During the last few years, the investment policies followed by trustees of corporate pension funds have caused considerable apprehension. These trustees, some observers have feared, may gain control over large sectors of American industry through the acquisition of a substantial proportion of outstanding common stock. Since 1950, following the National Labor Relations Board's ruling that pensions are a proper subject of collective bargaining, trustees have been purchasing common stock at an increasing rate, and these holdings, it is argued, may place trustees in a strong position to influence (or actually make) critical decisions in corporate enterprises by voting such stock.

Behind this argument is the implicit assumption that intervention by trustees in corporate affairs would substitute so-called "banker objectives" for "entrepreneurial objectives" and thus result in injurious consequences for the nation's economic growth. It will be readily recalled that similar fears (some of which were well-founded) were raised by the investment policies of life insurance companies when the rapidly growing assets of those institutions first gave them a strategic place in the capital market and before State regulations were adopted to safeguard the interest of policyholders.

The conclusion reached in this paper is that, while trustees of corporate pension funds may well acquire potential control of some individual companies through the ownership of common stock, this will probably not be tantamount to effective control over an appreciable number of corporations. Nevertheless, it is also suggested that the problem is of sufficient public interest to require an early examination by responsible public officials.[1] Before examining more closely the question of corporate control by pension fund trustees, however, it is well to take a brief look at the general characteristics of these funds and at the statistics describing their growth.

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Types of Corporate Pension Funds

Although corporate pension plans vary widely, the chief distinction for the present purpose is between insured and non-insured plans. The latter are administered by trustees, most of whom are appointed by employers although a few are jointly appointed by employers and trade unions. Non-insured plans pose the most serious problem and are discussed more fully below.

An insured plan is simply an individual or group annuity (conventional or deposit administration type) purchased by the employer from a life insurance company. Although in number individual annuities accounted for two-thirds of pension plans, group annuities (with an average of 640 persons per group in 1957) included more than four-fifths of all employees covered by insured plans.[2]

As shown in Table I, insured pension funds at the end of 1957 totaled \$13.7 billion, or 42 per cent of private pension funds; they also constituted 13 per cent of total life insurance companies' assets. Under most State insurance laws, life companies cannot administer pension funds separately from other policy reserves (although purely for accounting convenience the distinction is made), and in investing these funds they must follow the same regulations which govern the investment of other reserves. These regulations severely restrict the ability of life insurance companies to acquire common stock. For example, in New York State, whose regulations either directly or indirectly control the investment of over 90 per cent of all life insurance assets, companies can invest in common stocks (valued at market prices) only 5 per cent of total assets or one-half of surplus, whichever is smaller. Moreover, this restriction is reinforced by the fact that total surplus cannot exceed 10 per cent of total assets. The laws of most other states have similar provisions. Because of these limitations, it is unlikely that life insurance companies could use the pension funds under their care to acquire corporate control. Therefore pension funds held by these companies can be excluded from further consideration.

Growth of Non-insured Pension Funds

The growth of non-insured pension funds during the last decade is dramatically illustrated in the statistics compiled by the Securities and Exchange Commission (SEC). As shown in Table I, non-insured funds at the end of 1957 amounted to \$19.3 billion, or 58.5 per cent of all private pension funds (which totaled \$33.0 billion). Non-insured funds have accounted for an increasing proportion of total pension fund assets; the increase in the former was \$2.7 billion in 1957, a gain of 16 per cent and nearly twice the increase in insured pension funds.

The distribution of assets held in non-insured pension funds at the end of 1951 and 1957 and changes during the six-year period are shown in Table II. Corporate bonds, which totaled \$10.4 billion at the end of 1957, remain the chief outlet for pension funds, accounting for over one-half of total assets and absorbing nearly three-fifths of the increase since 1951. Pension fund trustees held \$2.0 billion of U.S. Government securities at the end of 1957, slightly less than in 1951. The declining importance of Government securities in pension fund portfolios reflects the simultaneous quest for higher earnings and a hedge against inflation.

This twin search has lead increasingly to larger holdings of equity securi-

TABLE I

ASSETS OF PRIVATE PENSION FUNDS*

(end of year; billions of dollars)

	1950	1954	1955	1956	1957
Corporate non-insured funds	5.5	12.2	14.2	16.6	19.3
Insured pension funds	5.4	9.8	11.1	12.3	13.7
Total	10.9	22.0	25.3	28.9	33.0
Corporate non-insured funds as a per cent of total funds	50.0	55.5	56.0	57.6	58.5

* Insured plans include funds of following groups: religious, educational, non-profit, unincorporated business and union administered.
Compiled from data published by the Securities and Exchange Commission and the Institute of Life Insurance.

TABLE II

DISTRIBUTION OF NON-INSURED PENSION FUND ASSETS, 1951 AND 1957

(millions of dollars, back value at end of year)

Type of asset	1951		1957		Changes in assets 1951-57	
	Amount	Per cent of total	Amount	Per cent of total	Amount	Per cent of total
Cash and deposits	291	4.2	368	1.9	77	.6
U. S. Government securities	2,170	31.6	2,032	10.5	−138	−1.1
Corporate bonds	3,125	45.4	10,392	53.8	7,267	58.4
Own Company	*	—	641	3.3	—	—
Other Companies	*	—	9,751	50.5	—	—
Preferred Stock	272	4.0	611	3.2	339	2.7
Common Stock	812	11.8	4,770	24.7	3,958	31.8
Own Company	246	3.6	584	3.0	338	2.7
Other Companies	566	8.2	4,186	21.7	3,620	29.1
Mortgages	*	—	313	1.6	940	7.6
Other Assets	206	3.0	833	4.3		
Total Assets	6,876	100.0	19,319	100.0	12,443	100.0

* Not available separately.
Computed from data published by the Securities and Exchange Commission.

ties, with common stock being the main attraction. While the book value of preferred shares rose from $272 million in 1951 to $611 million at the end of 1957 (more than a doubling of the total), common stocks increased by nearly six times and at the close of 1957 totaled $4.8 billion (book value), or one-quarter of total pension fund assets. Valued at market prices, common stock investments of pension funds accounted for 30 per cent of total assets at the end of 1957, compared with 32 per cent in 1956. The decline in the ratio reflected the downtrend in stock prices during the last half of 1957.

During the six-year period 1951-57, common stocks absorbed almost one-third of new pension funds compared with only 3 per cent for preferred stocks. On the other hand, SEC data show that, while equity capital has be-

TABLE III

SHARE OF NON-INSURED PENSION FUNDS IN NEW PURCHASES OF CORPORATE SECURITIES, 1951-57
(billions of dollars)

	1951-57 Total	1951	1952	1953	1954	1955	1956	1957
Common and Preferred Stocks								
Total	20.7	2.8	3.0	2.4	2.5	2.9	3.4	3.7
Non-insured Pension Funds								
Amount	4.4	.3	.5	.5	.6	.7	.8	1.0
Per Cent of Total	21.2	11.3	16.6	20.9	24.0	24.2	23.6	27.0
Bonds and Notes								
Total	36.9	4.1	5.1	4.8	3.8	5.5	6.1	7.5
Non-insured Pension Funds								
Amount	8.1	.7	1.0	1.0	1.2	.9	1.6	1.7
Per Cent of Total	21.9	17.1	19.6	20.8	31.6	16.4	26.2	22.7
All Corporate Securities								
Total	57.6	6.9	8.1	7.2	6.3	8.4	9.5	11.2
Non-insured Pension Funds								
Amount	12.5	1.0	1.5	1.5	1.8	1.6	2.4	2.7
Per Cent of Total	21.7	14.5	18.5	20.8	28.6	19.0	25.3	24.1

Computed from data published by the Securities and Exchange Commission.

come a main outlet for pension reserves, the proportion of total equity capital supplied by pension funds in the last few years did not expand as swiftly as during 1950-54 — the period of rapid growth in assets which followed increased emphasis on pensions in collective bargaining contracts. As shown in Table III, pension fund purchases rose sharply from 11 per cent of the net increase in equities in 1951 to one-fourth in 1954 and were unchanged in the following two years. In 1957, the proportion climbed again and reached a new peak of 27 per cent.

Future Role in the Stock Market

During the next decade, moreover, corporate pension funds may greatly expand their participation in the equity sector of the capital market. The general contours of this participation can be deduced from projections of pension fund growth relative to the increase in the outstanding volume of equity securities. In a paper prepared in the fall of 1957,[3] Vito Natrella of the SEC estimated that non-insured pension funds will have total assets of $51.7 billion at the end of 1956. Natrella assumes that these funds' holdings of common and preferred stocks will approximate $16 billion and will account for 30 per cent of their assets in 1965—compared with equity holdings of $4.4 billion (amounting to 26 per cent of assets) in 1956. This assumption implies that about one-third of the net increase in total assets of non-insured pension funds during the nine-year period would go into common and preferred stocks—the same proportion as in 1956.[4]

Under the above assumption, the impast of pension fund growth on the capital market promises to be considerable in the years ahead. For example, if the volume of equity securities outstanding only repeats the average annual dollar gains (2.8 billion) registered between 1951 and 1957, the total outstanding in

1965 will approximate $372 billion, an increase of 21 billion from the 1957 level. If non-insured pension funds hold $16 billion of equity securities in 1965 (as Natrella assumed), their share of the total will be about 4.3 per cent, compared with less than 2 per cent at the end of 1957. This result follows, of course, from the assumption that pension funds' holdings of equities will grow at a much faster rate than volume of equities outstanding. But even if the rate of growth in outstanding equities during the next eight years is double that of the 1951-57 years, the total volume outstanding in 1965 would be about $409 billion, and the proportion of the total held by pension funds (16 billion) would still be close to 4 per cent. Since Natrella's projection of non-insured pension funds' assets through 1965 does not seem unreasonable, and since the average annual increase in common and preferred stocks outstanding probably will not exceed $6 billion, it appears that the relative importance of pension funds in the equity sector of the capital market will more than double by the end of 1965.

RECENT COMMENTS

Most observers who have commented on the potential control of corporations by pension fund trustees either simply describe the statistics on pension fund growth or present some variation of the central argument outlined above.[5] Among such commentators are Paul Howell, Peter Drucker, Adolf Berle, Jr., and Seymour Harris. The views expressed by the first three writers are discussed more fully below. Professor Harris, in testifying before a congressional committee, called attention to the rapid growth of pension funds and suggested that they are a source of financial power that could be abused.[6]

On several occasions, Paul Howell, an economic consultant and expert on pension funds, has commented on the growing importance of pension funds and has warned that this may enable a few trustees to control a large segment of industry. In 1957,[7] he suggested that one should distinguish sharply between the concentration of *wealth* (or claims on assets) and the power to use it to influence decisions by managers of business enterprises. He observed that the control of pension funds could rest with three groups (workers, employers, and trustees), but that the influence of the first two can be considered as insignificant. Far from having control of pension funds, workers usually are not even consulted about their disposition, although some collective bargaining contracts do provide for joint administration of investments. In many instances, employer-corporations control their *own* pension funds, but this type of control affords little advantage — except in a proxy contest.

The key problem, then, arises from the concentration of pension funds in the hands of trustees who are free to purchase — and vote — large blocks of common stocks issued by a variety of enterprises. Although the evidence is fragmentary, it seems that commercial banks are the leading trustees. For example, a 1955 survey by the New York State Superintendent of Banking[8] (which provides virtually the only details on concentration of pension funds among trustees) found that 13 New York City banks were trustees for $6.4 billion of pension funds, an amount equal to 90 per cent of such assets held by all New York State banks and just

under one-half the national total of non-insured pension funds at the end of 1955. However, three-fifths of the pension assets held by New York State banks were in debt rather than equity securities, and this fact, Howell correctly concludes, greatly reduces the potential control of industry by these fiduciaries.

Nevertheless, on the national level the problem still exists, since at the end of 1957 non-insured pension funds owned $5.4 billion of preferred and common stock. While this was less than 2 per cent of the total then outstanding, it was probably one-sixth of the amount held by financial institutions. Much of Howell's argument turns on this last point. According to him, "since many of these financial institutions think and act alike, it may be said that a substantial nucleus for the exercise of concentrated power exists as opposed to the scattered ownership of individuals." While admitting that he has no solution to the problem, Howell implies that, since the rate of growth of pension funds will decline during the next decade, the normal expansion of the general economy will reduce, if not eliminate, any adverse consequences which may result from the concentration of funds in the hands of trustees.

Peter Drucker (a business consultant and New York University professor), presents a comprehensive treatment of pension funds as potential sources of corporate control.[9] After reviewing the rapid rise of pension funds and the concentration of their assets in the hands of trustees, Drucker poses the problem by asking the following questions:

> . . . Should the fiduciary trustees . . . exercise the right to control the management of companies whose legal owners they are? Should they demand a place on the board of directors, appoint and remove management people, review and approve company decisions? Are they entitled to exercise this control even though they are only "legal" owners? Or should they take the attitude, as trustees, that they are neither entitled to nor responsible for management of business? They are investors, not entrepreneurs, and the money they have invested is not theirs anyhow. Should they religiously refrain from any control—perhaps even be forbidden, as some industrial managements contend, from ever voting the stock which is legally in their name?[10]

Like others who have considered the problem, Drucker answers the above questions in a somewhat ambivalent fashion. He believes the trustees' self-consciousness at having so much financial power will restrain any propensity to exercise managerial control in the short run. Yet he also suggests that outside advisers, independent of both trustees and corporations but still in close contact with each group, should be appointed by the parties involved to provide objective advice on investment and operating problems. These independent advisers, who may be distinguished industrialists or men in public or academic life, would not only advise trustees when to buy or sell a corporation's stock but would also suggest when it is desirable for the trustees to vote their stock holdings and thus exercise whatever power over the enterprise they may have.

Drucker reports that most pension fund charters being written today prohibit purchases by the trustee of the employer corporation's own stock, and many of them also forbid the investment of funds in stocks of competing firms. Moreover, such charters usually place a low limit on the proportion of the fund's assets which can be invested in a single company and further prescribe that the fund can purchase only a small fraction (5 to 10 per cent) of the

capital of any one company. However, Drucker considers such restrictions as having little force. In his view, trustees collectively would still dominate a company's affairs—unless they voluntarily decided not to do so. "... They would all normally tend to think and act alike; they are people with the same interest, the same training, and the same responsibilities. As for controlling industry, it would really not make much difference whether there were one or twenty such fiduciary investors. . . ."[11]

Finally, most pension fund charters are written on the tacit assumption that the trustees will not vote the stock they own. If they are dissatisfied with corporate management, they presumably are free to sell the stock and withdraw from any contact with the enterprise. However, Drucker observes that the large size of such holdings would probably mean that only another institutional investor could take them up—a most unlikely solution, since the latter do not generally invest in an enterprise to which the slightest suspicion attaches. At times, moreover, there may be situations in which trustees probably *should* vote their holdings in a firm to prevent its looting by speculators who may gain control through acquiring as little as 10 per cent of outstanding common stock.

Thus, Drucker sees shortcomings as well as advantages in the way pension fund trustees view their power and responsibilities. Since he looks to them as the potential source of much of the equity capital required for future economic growth, he accepts the necessity to devise some means of checking the power which will inevitably accrue to them if they provide such capital. He believes the appointment of independent advisers is the first step in the evolution of these checks.

Adolf A. Berle, Jr., a professor of law at Columbia University, has discussed the implications of pension fund growth along lines similar to Drucker's.[12] However, while admitting that such funds have, thus far, deliberately refrained from participating in the corporations whose stock they own, he doubts that they will decline indefinitely to use the power they hold. Yet he seems prepared to rely on the force of public opinion to keep check on the behavior of trustees.

CONCLUSIONS

It is clear from the foregoing discussion that the prospective growth of corporate pension funds, which are expected to continue investing large amounts in equity securities, may provide a vehicle through which pension trustees *can* exercise substantial control over industrial management. It seems that, as a minimum, the funds will hold between 3 and 4 per cent of total equity securities outstanding in 1965. Moreover, they will probably hold significantly larger proportions of the total outstanding stock of many industrial companies; this seems likely because pension funds—although they attempt to diversify their equity portfolios through acquiring the stocks of numerous companies—actually restrict their purchases to a relatively small range of outstanding issues, among which the so-called "favorite 50" are quite prominent. Thus, even though they will probably broaden their interests to include a wider selection of issues in the future, the concentration of ownership may be sufficient to place effective control of many of the strongest companies with the trustees — provided the latter are

inclined to take advantage of their strategic position. Nevertheless, even if such a high degree of concentration were to materialize, trustees would still not have comprehensive control of American industry.

Up to the present, moreover, trustees generally have refrained from the exploitation of the opportunities they already have to effect changes in the policies of those companies whose stocks they own. Furthermore, there is no reason to assume they will reverse their position in the near future. Nevertheless the situation is a potential source of concern and perhaps now is the time to start thinking about possible safeguards against unreasonable or socially undesirable exercise of power by pension fund trustees.

None of the writers cited seems to have a final solution for the problem discussed here. Howell's assertion (that the normal expansion of the economy will resolve the difficulty) certainly does not satisfactorily dispose of the issue. On the contrary, the estimates of future pension fund growth suggests that the possibility of control by trustees will actually increase in the years ahead. While the evidence to date strongly supports Berle's case for reliance on public opinion to induce trustees to limit the use of their power voluntarily, the pressure to invest funds in the future may result in a greater willingness on the part of these managers to risk public censure by exercising their potential control over corporate enterprises to guarantee profitable outlets for their funds.

Drucker's suggestion that independent advisers should play a mediating role between trustees and corporations —which to some may appear attractive on the surface—actually falls short of a real solution. While such a relationship is conceptually feasible, it would probably be impossible for advisers to maintain an independent role in practice. Since the pension fund trustees or the corporation would retain the power to appoint and dismiss advisers, the latter would actually be dependent on the former. Consequently, they would most likely tailor their performance to keep within the good graces of trustees or corporate management.

On the whole, then, if public opinion seems a dubious check on the potential control of corporations by trustees of pension funds, and if privately appointed advisers cannot be expected to exert much influence on those who appoint them—what *is* the solution? Perhaps it is well to recognize that the question, although of considerable public as well as analytical interest, cannot be answered unless State laws are re-written to reduce the wide area of discretion currently allowed trustees—whether of pension funds or of other types of private property.

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[1]The recent success of trustees for the Samuel H. Kress Foundation in gaining control of S. H. Kress & Co., a variety store chain, demonstrates that the possibilities described by several writers do exist. Of course, the Foundation differs substantially from a corporate pension fund, but the experience does illustrate the general problem dealt with here.

[2]Institute of Life Insurance, *Fact Book, 1958*, pp. 36-38.

[3]"Implications of Pension Fund Accumulations," presented at the 117th Annual Meeting of the American Statistical Association, September 10, 1957, Atlantic City, New Jersey.

[4]Equities absorbed somewhat more than one-third of the increase in pension fund assets in 1957.

[5]In the extensive investigation of welfare and pension funds by the United States Senate, virtually no attention was given to this issue. Instead, considerable emphasis was placed on the risk involved when beneficiaries' funds are invested to a large extent in the employer-company. Cf. *Welfare and Pension Plans Investigation, Hearings, and Final Report*, Subcommittee on Welfare and Pension Funds, Committee on Labor and Public Welfare, United States Senate, 84th Congress, First Session.

[6]See *Welfare and Pension Plans Legislation, Hearings*, before a subcommittee of the Committee on Labor and Public Welfare, United States Senate, 85th Congress, First Session, p. 409.

[7]"High Cost of Financial Conservatism," an address before the American Finance Association, December 29, 1957, Philadelphia, Pa.

[8]George A. Mooney, *Pension and Other Welfare Plans*, New York, 1955.

[9]*America's Next Twenty Years*, New York, Harper and Brothers, 1957, chap. 3.

[10]Ibid., p. 45.

[11]Ibid., p. 47.

[12]*The 20th Century Capitalist Revolution*, New York, Harcourt, Brace & Co., 1954, pp. 72-74.

INLAND WATERWAYS AND SPECULATIVE THINKING

Geographically considered, no city is so favorably situated as Philadelphia, for commanding the whole inland trade of the continent. Seventy-five miles of canal are all that is needed to give full water communication with the Pacific Ocean via the mouth of the Columbia River.

Editorial in a Philadelphia paper, about 1830. Quoted in Madeline Sadler Waggoner, The Long Haul West *(New York: G. P. Putnam's Sons, 1958).*

HARRY G. BRAINARD

American Investments Abroad

One of the most important economic factors in world affairs, foreign investment of American money, is considered in its general aspects. A later article will deal with special problems.

Since World War II there has been a growing interest by the people of the United States in world affairs, ranging from such topics as military commitments, political alliances, and social developments to economic problems. Much less attention, however, has been given to particular aspects of these topics. Thus an attempt will be made here to deal with a single phase of international economics, namely, American investments abroad. In the present discussion, and in that which will appear in a subsequent issue of this magazine, an endeavor will be made to examine the whole problem of United States investments abroad as an important economic factor in world affairs.

In this article attention will be directed to a study of the general situation with respect to private investments in foreign countries and to an analysis of the distribution of these investments by industry and by area. On the basis of this discussion we shall try to answer two major questions: Why does American business invest abroad, and why is United States capital wanted in foreign nations? The second article will focus attention on two broad topics: the problems faced by the American investor abroad and the problems that arise in a foreign country as a consequence of United States investments. In the final part an effort will be made to draw some broad general conclusions that may have policy implications.

As a young and growing nation the United States was an attractive place for foreign capital to find profitable employment. Thus it was not until the end of World War I that on balance American investments abroad exceeded those held in this country by foreigners; we became a creditor nation and have maintained that position ever since. The position of the United States with respect to long-term investments abroad for the past 38 years or so is shown in the accompanying table. This table also indicates the extent of foreign investments in the United States.

Without going into great detail, cer-

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TABLE 1

AMERICAN LONG-TERM FOREIGN INVESTMENT POSITION, 1919-1957
(in billions of dollars)

	1919	1930	1939	1946	1950	1954	1957
U. S. Investments Abroad, Private							
Direct	3.9	8.0	7.0	7.2	11.8	17.6	25.3
Portfolio	2.6	7.2	3.8	5.0	5.7	6.7	8.3
Total	6.5	15.2	10.8	12.2	17.5	24.3	33.6
U. S. Government	—	—	—	5.0	13.5	15.2	15.5
Grand Total	6.5	15.2	10.8	17.2	31.0	39.5	49.1
Foreign Investments in the U. S., In Private Securities							
Direct	.9	1.4	2.0	2.5	3.1	4.0	4.8
Portfolio	2.3	4.3	4.3	4.5	4.6	7.0	8.0
Total	3.2	5.7	6.3	7.0	7.7	11.0	12.8
In U. S. Government Bonds	—	—	—	.4	1.5	1.1	1.5
Grand Total	3.2	5.7	6.3	7.4	9.2	12.1	14.3
Net Position—Private Investments	3.3	9.5	4.5	5.2	9.8	14.3	20.8

Source: *Balance of Payments*, Statistical Supplement, Office of Business Economics, U. S. Department of Commerce, 1958, p. 178. Also *Survey of Current Business*, September, 1958, p. 16.

tain observations are clear with respect to the private segment of America's long-term investment position as it has evolved over the years. The trend since the end of World War II is especially striking.

1. United States private capital has moved abroad in an astonishing volume since 1946 and even though foreign funds have come to this country, the total amount is not large. As a consequence the net position of American investors has grown rapidly, from $5.2 billion in 1946 to $20.8 billion in 1957, a 400 percent increase in 11 years.

2. There is a sharp contrast in the character of foreign investments made by Americans and investors from abroad. While investments of the portfolio type have shown some growth, especially since 1950, capital from this country flows largely into direct holdings abroad. Foreigners, on the other hand, have neither expanded firms already owned nor established new ones to any great degree; they have preferred instead to buy securities in American companies. In other words, American management and control follow its capital, while foreigners seem content to be holders of stocks and bonds.

3. A final observation is that extensive lending abroad by the United States government is a phenomenon of the period since the end of World War II. This is a reflection, of course, of the efforts our government has made to assist the nations of the free world in the struggle against communism.

PRIVATE INVESTMENTS

To say that American private investments abroad of the long-term type stand at more than $33 billion, while significant, does not tell the whole story. There is much more to be said. To begin, it is necessary to say something about the investors themselves. Once this is done, it is then possible to discuss in meaningful terms the distribution of United States investments abroad by area and by industry and, finally, to investigate the reasons for the pattern that prevails.

The conditions that give rise to foreign investment frequently influence its character and the particular form it takes. Thus there are "money investors" whose primary objective is to earn returns higher than those that prevail domestically. To do this they buy the securities of foreign corporations and governments. These are portfolio investments and consist of stocks and bonds. The money investor, therefore, is generally not interested in participating in control, but rather in earnings and possibly speculative gains. The "business investor," on the other hand, invests abroad, not only for the earnings that may be obtained, but also to improve the profit position of his entire operations. He makes a direct investment by acquiring a substantial interest in a foreign enterprise or by establishing a subsidiary firm abroad. These are direct investments.

Since direct investments constitute about three-fourths of the total, it is important to acquire some knowledge of their geographical and industrial distribution. Chart I, which is based on a recent study by the United States Department of Commerce, shows for 1957 the areas of the world and the industries in which American businessmen have invested.[1] It is to be noted that the value of total direct investments abroad is probably larger than the $25.3 billion indicated, since book rather than market value figures have been used.

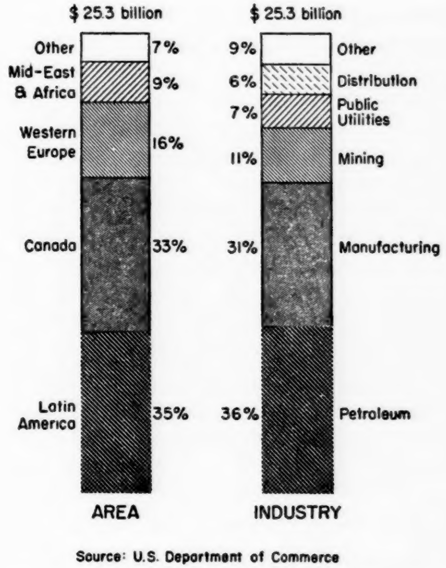

Chart I—Distribution of U. S. Direct Foreign Investments, 1957

From this chart a startling fact becomes evident: American businessmen have invested very heavily in petroleum and manufacturing, and more than two-thirds of the total has gone to countries in the Western Hemisphere. In other words, direct capital has not been invested on a broad scale throughout the world and it has not been put into widely diversified types of industries.

If one goes behind these over-all figures and investigates particular areas

and industries, interesting contrasts appear. In Latin America, for instance, major emphasis has been placed on developing and expanding the petroleum industry, with a major proportion of the funds being concentrated in Venezuela. Thus in 1957, out of a total investment of $8.8 billion, holdings in petroleum amounted to $3.2 billion, or nearly 40 per cent. Of the remaining sum, $1.7 billion was devoted to manufacturing and the rest was invested in other types of industries. For the same year the Canadian picture was quite different. Out of total Canadian investments of $8.3 billion, manufacturing accounted for $3.5 billion, namely 42 per cent. Petroleum was the next most important industry with an investment of $2.2 billion, and the remaining amount was distributed among the other categories.

So far as other areas are concerned, it is apparent that Europe is considerably more important than the Middle East and other regions. This may come as somewhat of a surprise, since it might be assumed that oil resources in Iran, and other countries of the area would attract large volumes of American capital. The investment picture in Europe in 1957 is interesting since it too shows heavy concentration in manufacturing, $2.1 billion, and petroleum, $1.2 billion, out of a total of $4 billion. Investment in manufacturing enterprises in European countries is easy to understand. But what about petroleum? Are there oil resources in this area? The answer is that American businessmen have invested heavily, not in petroleum production, but in refining and distribution facilities with a good deal of concentration in the United Kingdom.

Up to this point we have been talking about the American firm or businessman who puts his money directly into an enterprise in a foreign country. He does not think of himself as an investor, but rather as a producer of raw materials, a manufacturer, or a merchant, who is doing business abroad. This business may be an extension of a domestic firm such as General Motors or General Electric, or it may operate exclusively abroad in the pattern of the W. R. Grace and Company. In any event a direct investment carries with it the notion of more or less permanence. Capital may go into foreign countries, however, under different circumstances. The money investors, as indicated earlier, are not interested in operating a business abroad; rather, they seek profitable sources of investment for funds which they have at their command. Thus they buy stocks and bonds of foreign corporations.

As was shown in Table 1, portfolio investments are only about a quarter of total foreign holdings, but it should be pointed out that an increasing interest is being shown in these securities. Data are not available showing a breakdown of portfolio investments by industry, but information is available with respect to geographical distribution. In 1957, portfolio holdings totaled $8.3 billion, of which $4.2 billion, or more than one-half, was invested in Canada. Another $1.8 billion was invested in firms of Western Europe, and less than a billion dollars was in Latin America.

WHY CAPITAL GOES ABROAD

There are many explanations for the movement of United States capital into foreign enterprises and industries. And these are not necessarily the same for the money investor as for the direct investor. Because this is so, it seems

desirable to treat separately the motivating forces behind portfolio and direct investors and to describe each briefly.

Former Investments

In the decade of the 1920's a popular type of foreign investment was central and local government bonds, especially of countries in Latin America. The bonds carried interest considerably higher than similar domestic securities and they were pushed by investment houses, since the commission was also high. Individuals, banks, and institutional investors were drawn into this market. Investors in these portfolio securities lost extensively in the depression years that followed and for this reason the market for portfolio investments has not had a great attractiveness to Americans until lately. There is now, however, an active interest in foreign securities and the funds are provided largely by enterprises established for the specific purpose of investing abroad. This is in contrast to the investors of the 1920's whose portfolios contained both domestic and foreign securities.

Current Money Investments

The current money investors fall into one of four categories, according to an official of the Chase International Investment Corporation.[2] There are, first of all, people of great wealth who invest abroad as individuals or through personally owned investment enterprises. In some instances the motivation behind their foreign investments is to gain a tax advantage. Where this is the case, the holdings are largely in land and real estate. There are, however, other people with large fortunes whose objective in making investments abroad is positive rather than negative. The activities of the Rockefellers are the best known of this group. In 1947 they established the International Basic Economy Corporation with an initial capital of $12 million. It now has a capital of $16 million and assets of over $33 million. The purpose of this enterprise is to furnish capital along with technical and organizational skill to commercial projects principally in underdeveloped areas. Its investments are distributed in all parts of the world and in a wide variety of activities ranging from agriculture to manufacturing, to distribution, to finance.

A second type of money investor is represented by the more usual kind of investment trust, and several of these have come into existence largely for the purpose of investing in Latin America and Canada. International Resources Fund, Inc., for example, was organized in 1955 and has assets of about $16 million. It has invested in the securities of companies engaged in, or related to, any phase of the exploration, production, extraction, distribution, or processing of natural resources. Other firms falling in this category include International Investors, Inc., International Fund, Inc., which is a Pan-American corporation organized and managed by Wood, Struthers & Co. of New York, and Inter-American Capital Corporation, also incorporated in Latin America and organized and managed by an American firm. A third kind of portfolio investor is typified by the enterprise that has had for some time foreign operations but is seeking diversification and completely new lines of business. Among this group may be listed W. R. Grace and Company, South American

Gold & Platinum, and Electric Bond & Share.

A final category of money investors consists of investment and commercial banking firms that directly, or through subsidiary companies, conduct investment operations abroad in a manner similar in many respects to the Swiss investment banks. In some instances firms invest for the account of clients and in other cases they carry on these activities for their own benefit. The American Overseas Finance Corporation, for example, was organized some years ago by several United States commercial banks to finance exports and also to purchase securities in foreign enterprises. For its part the Chase Manhattan Bank has recently established the Chase International Investment Corporation with a modest capital of $15 million. This firm has equity investments in foreign enterprises and is contemplating an expansion of its activities.

The subjects of the size and distribution of private investments as well as the types of investors involved can well be followed by an analysis of the factors behind the flow of American capital to foreign countries. As has already been mentioned, money investors purchase foreign securities where earnings and speculative gains are more attractive than at home. Furthermore these investors hope, by putting their funds into the securities of foreign corporations and governments, to obtain a better balance in their portfolios than would otherwise be the case. It must be remembered, however, that money investors desire to retain as liquid a position as possible, not intending to continue permanently any particular investment whether it be domestic or foreign.

Current Direct Investments

Direct investments abroad come from sources entirely different from the portfolio type, and frequently the motivation behind these capital movements varies. It is probably safe to say that a major proportion of the $25.3 billion invested directly in foreign countries came from funds possessed by American industrial and commercial enterprises and not from the banking community. And this should come as no surprise because in essence many direct investments abroad represent simply an extension of domestic operations. The investment may take the form of a wholly-owned subsidiary or of a foreign corporation in which the stock interest is substantial, but not complete. Thus, for example, many Canadian corporations are independently established but owned partly by United States firms. Since this is the nature of direct investment and since American firms provide most of the funds, it goes without saying that these holdings are considered as relatively permanent in nature. This is in contrast to the portfolio investor who desires to keep his funds reasonably liquid.

Because of the very nature of direct investments it is almost certain that factors other than the potential profitableness of a particular venture, influence the decision of the domestic firm to commit its funds abroad. In other words, General Motors and Standard Oil of New Jersey are in business to make money, but this does not mean that a foreign subsidiary by itself must show a profit. Over a period of time, of course, a foreign subsidiary must contribute to the over-all earnings of the parent company.

Since it is not possible here to suggest all the various reasons, aside from profit, for making direct investments in foreign countries, only the most important ones will be outlined. A controlling factor in many instances is the desire of a firm in this country to improve its raw materials position. It is this consideration which has led various steel companies to invest millions of dollars in mining iron ore in Labrador and in Latin America. For the same reason Firestone has invested heavily in rubber plantations, and oil companies have committed millions of dollars to petroleum exploration and production in Canada, Venezuela, and the Middle East. In each of these instances the firms concerned have sought additional supplies of raw materials essential to the over-all operation of their enterprises. Without these resources the profit position of the parent firm might deteriorate seriously.

The Influence of Tariffs

Another consideration of prime importance to United States firms relates to their position in world markets, and this factor assumes a new significance with the emergence, in 1959, of the European Common Market. Within the area consisting of Benelux, France, West Germany, and Italy there will prevail a new and expanded market since most trade restrictions will disappear. Around the region, however, there will be a single tariff wall. Now if American firms are to participate fully in this enlarged market, it seems quite likely that subsidiary companies already existing will have to be enlarged and new ones established. The reason is that the new tariffs may be sufficiently high to keep out many American-made products.

A firm does not necessarily have to establish production facilities abroad in order to expand its markets. This is especially so for merchandising enterprises, with Sears, Roebuck and Company as an outstanding example. This enterprise undertook a few years ago to expand its operations by establishing stores, warehouses, and other facilities in Brazil and Mexico City. The company now has more than 20 stores distributed in various Latin-American countries. The Woolworth Company has done much the same thing with stores as near as Canada and as far away as Australia.

American-owned manufacturing firms in Canada enable the parent corporations to participate more fully in that market by avoiding tariffs and by tailoring their products to consumer requirements. There is also another advantage. Products made by United States firms in Canada qualify for tariff preferences available only to members of the British Commonwealth of Nations, thereby indirectly expanding the market of the parent companies. More could be said on this topic, but this is sufficient to indicate why, through direct investments, American firms have access to larger markets.

The Influence of Costs

There is yet another reason for direct investment abroad and it relates to costs of operation. There are many instances of American-made products being too costly in the foreign market; at lower costs substantial sales might be made. To solve this problem it is not unusual for companies in this country to establish manufacturing operations abroad. In this way transportation costs are reduced or eliminated and the firm is also

able to take advantage of lower production costs. A broader market is obtained by the extended operations. There is also another direction this particular situation may take. Because of lower costs of production abroad a company in this country may actually import from its foreign operations certain items that can be made more cheaply there than at home. The major automobile firms are importing cars made by foreign subsidiaries rather than manufacturing these small automobiles here. There is an indication of a similar development in the watch industry. Because of lower costs certain types of watch works are being produced by American owned firms abroad and imported for sale throughout the nation.

In sum, then, it can be said that while the objective of a direct foreign investment is to improve the profit position of the parent firm, there are other factors that are considered. Among these we have mentioned the necessity to obtain essential raw materials, the desire to broaden participation in the foreign market, and the ability to reduce costs by producing abroad.

With this analysis of the factors that motivate direct and portfolio investments abroad, let us turn now to a study of the reasons why foreign nations want United States capital.

WHY THEY WANT OUR CAPITAL

From the middle of the 19th century to World War I the investment bankers of England and Europe constituted the principal source of capital for foreign investment. The Barings of London and the Rothschilds of Europe are legendary in their roles in financing commercial and industrial developments in the United States and other areas. They also provided extensive financial assistance to various governments and made funds available for the prosecution of the Crimean War. By the 1920's New York's Wall Street had also become a world financial center and large amounts of money were invested abroad. By this time American firms were also in a position to expand their operations abroad and make substantial direct investments. Since the close of World War II the United States has occupied the role of the main source of capital for foreign investment in the free world. And as has already been indicated, about three-fourths of it has been of the direct type.

What all this means is that enterprises in foreign areas have looked to the United States for capital. This does not mean, however, that private capital is not available elsewhere, because it is. Thus in recent years increasing amounts of funds have been invested abroad by the British and also by German capitalists. The fact remains that American firms are still the largest, if not the only, source of foreign capital.

Skills as Well as Capital

Foreign businesses directly or with the assistance of their governments turn to the United States, not only because it is the main source of capital but also because of the technology and managerial ability that may come with direct investments. In more precise terms what this means is that certain countries possess vast natural resources which domestic firms cannot develop and exploit, not only because of a lack of capital but also because of inadequate technical knowledge and organizational training. The development of petroleum resources in Venezuela has come about as a consequence of two factors: Ameri-

can firms want to expand their supplies and reserves, and the government of Venezuela is anxious to obtain the revenue that comes from such development. But this is not always the case. Brazil has extensive petroleum resources and even though it lacks capital and know-how for their exploitation, it is unwilling to admit foreign enterprises to do the job. As a consequence it continues to import oil.

The development of the vast iron ore resources of Labrador is another illustration of an instance where exploitation can be promoted with the use of United States capital and technical knowledge. To make the ore reserves available requires not only very large sums of money but also the experience of firms already in the business. United States firms want access to these ore deposits and have been willing to provide capital and engineering resources. In the case of Labrador, Canadian enterprise also wants to promote the development of this natural resource and has, therefore, participated in this joint venture. Thus to promote the exploitation of natural resources, oil, iron ore, copper, and so forth, American capital and with it technical and organizational skills have been sought after by various foreign enterprises and governments.

Stages of Development

In the past decade great emphasis has been placed on the ways and means to promote the economic development of various nations throughout the world. It has been pretty generally assumed that economic development is in a sense a two-step undertaking. First of all it is essential to create basic economic equipment or facilities before industrial and commercial growth can take place. Highways and harbors must be built; power facilities must be developed; agriculture must be improved; and the social and political needs of the people must be provided. All these projects and programs require large volumes of capital and do not, except over a long period of time, promise much in the way of profits. Thus to the extent that outside capital is required, foreign governments must look to other nations and various international lending agencies, such as the International Bank for Reconstruction and Development, for funds. Our own government, through its foreign economic assistance projects, has provided substantial funds through loans and grants, and the United Nations technical assistance program has also extended aid.

Once these social capital facilities have begun to appear, the second step in economic development can get underway. This stage involves the exploitation of natural resources, the establishment of industries, an expansion of a nation's banking and credit facilities, the development of service enterprises, and the organization of all the other phases of a modern economy. In most cases these activities can be carried on by private enterprise, and direct investments from abroad provide a part of the capital requirements.

Private foreign capital plays its most important role in promoting economic development in at least two directions. If an underdeveloped country possesses oil or other scarce natural resources, then, as has been indicated, United States private capital may participate in its exploitation and thereby make extensive funds available to the host nation. The acquisition of large supplies of dollar exchange by such means may contribute significantly to economic de-

velopment as in Iran. It cannot be assumed, however, that this will always be the case. The situation in Saudi Arabia is instructive in this connection, since it seems clear that the ruling class dissipates its oil royalties on personal luxuries rather than promoting the welfare of all the people.

Foreign private capital invested in industrial and commercial enterprises can contribute much to the economic growth of a country. The impact of Sears, Roebuck and Company activities in Brazil, for example, has extended far beyond those in connection with its merchandising. At first because of import restrictions and now because of good business practice, this firm obtains a large percentage of its products from native manufacturers. It has gone to local industries with specifications and designs and, where necessary, taught these producers how to make the goods it needs. As a consequence of the requirements of this firm, the industrial capacity of Brazil, Mexico, and other Latin American countries has been greatly expanded.

Native Employment

The practices of the W. R. Grace and Company are instructive, since they suggest another method by which foreign investors can promote economic growth. This firm, which has widely diversified interests in Latin America, has a fixed policy of employing native labor to the greatest possible extent. This includes filling executive positions with citizens of the country in which the particular firm is located. To make this policy effective extensive training programs are essential, and Latin Americans are frequently brought to the United States for this purpose. An important result of this policy is that many of the domestic firms which compete most effectively with Grace enterprises are managed and sometimes owned by former employees. This means that as a result of the activities of an American enterprise, Latin Americans are learning industrial and commercial techniques essential to economic development.

In sum, it is not correct to assume from what has been said in this article that the investment of private capital abroad is always advantageous, either to the investor or to the host country. The American who invests abroad is faced with many difficult and perplexing problems; and for the host countries the presence of foreign capital within their boundaries creates serious situations. Because these problems are too complex for a brief analysis here, the writer will not attempt either to pose or analyze them at this time. A thorough study of the problems involved, however, will appear in the next issue of this magazine.

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[1]Samuel Pizer and Frederick Cutler, "Private Foreign Investments Near $37 Billion," *Survey of Current Business*, September, 1958, p. 15.

[2]See V. E. Rockhill, "American Private Investments Overseas," a speech before the International Management Division of the American Management Association, April 2, 1958.

WILLIAM LAZER

Perspectives of Sales Forecasting

A comprehensive program:
• procedures • techniques • results

Modern business management may best be characterized as management by objectives. As such it is becoming increasingly conscious of planning company operations to achieve well thought out and realistic goals. More than ever before, it is concerned with the development of systematically-planned, highly-coordinated, and goal-directed systems of business action.

In such a business environment the attainment and utilization of effective sales forecasting becomes a consideration of paramount importance to management. For it is only through the use of adequate sales forecasts that realistic objectives can be effectively determined and an integrated and coordinated use made of company resources to achieve them. It is also against this backdrop of the development of purposeful and forceful systems of business action that the oft-stated truism, "a company may only decide how it will forecast and not whether it will forecast", takes on full meaning.

As one of the more important factors governing the operating effectiveness of companies today, sales forecasting promotes and facilitates the proper functioning of all the various segments of a firm's total spectrum of activity. It governs almost every other prediction of business action. It affects the budgets which are set, and is used in establishing controls and determining various limiting conditions for management programs. It is a useful tool for coordinating all the varied and integral aspects of business operations. The sales forecast also serves as a basis for evaluating the functioning and productivity of various components of business action. It becomes a guide that leads businesses toward the achievements of their implicit and explicit objectives.

It is the purpose of this article to consider various dimensions of sales forecasting, specifically the nature of sales forecasting as an integrating tool of management, sales forecasting as part of the total information process, and the basic procedures, techniques and results of a comprehensive sales forecasting program.

AN INTEGRATING TOOL

Although sales forecasting may be viewed in various ways, essentially it is an integrating management tool. Ef-

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fective sales forecasting integrates the external, non-management forces with the internal forces of a company. It reduces the external business environment over which management has little or no control to a controllable company environment. It delimits and translates those forces which establish the boundaries within which a company must operate and make decisions.

By so doing, sales forecasting enables a firm to take into account the impact of external factors that have an influence on company operations. Sales forecasting translates these into internal company affairs which can then be properly planned, organized, and controlled through company programs. Sales forecasting incorporates those affairs over which management does not have control into matters which can be controlled through company operations.

The Environmental Framework

Chart I portrays both controllable and non-controllable factors which management must recognize and take into account in making decisions. The forces involved determine the broad environment within which company operation must be conducted. Yet a whole group of these factors cannot be controlled by a company: at best it must appraise them intelligently. Included among them are the cultural forces, the economic environment, the political factors, existing overall broad industry conditions, and various international forces.

The competitive environmental and technological factors are distinguished from the other non-controllable factors in Chart I by the use of broken lines. The purpose of this is to indicate that, to a degree, management can have an influence over at least these two external factors. They are referred to as partially-controllable. Yet even though company action affects competition and technology, forces beyond company control generally have a more significant impact on them.

Such factors as those cited above comprise a company's external business climate. They, indeed, have a significant influence on company sales through time. This influence must be analyzed and evaluated before effective sales forecasting may be pursued.

The necessity of accounting for the future external climate becomes more and more imperative as sales forecasts take on the characteristics of longer-range predictions. Non-controllable factors establish the overall limits and boundaries within which companies survive and grow or fail. Their relationship to the future developments of company sales is often extremely crucial. It is from an evaluation and projection of non-controllable forces that management attempts to draw realistic assumptions about the future non-company framework which will exist and within which sales must be made.

In actuality, assumptions about non-controllable management factors underlie and are the bases of the actual sales forecast itself. Only by making these basic assumptions about the future external business environment, whether implicitly or explicitly, can management make intelligent sales predictions.

This initial step of determining the environmental framework within which a business must function is indeed an important one in sales forecasting. It should not be regarded as a theoretical

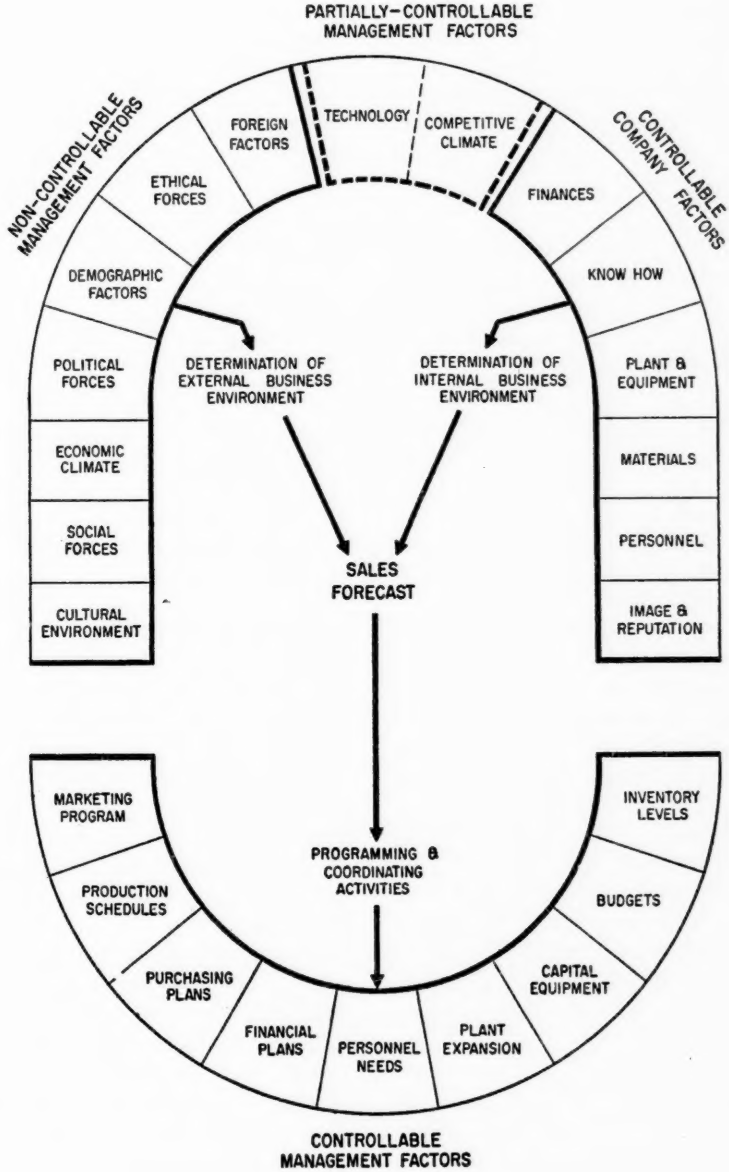

Chart I—Sales Forecasting: an Integrating Management Tool

exercise which is of little use in practical forecasting matters. External factors are a most relevant set of variables which must be dealt with practically and realistically. Although forecasters may sometimes tend to underplay the measurement of the impact of non-controllable forces, because of the complexities involved, these factors should not be ignored.

For one practical example of the paramount importance of external forces one might consider the power industry. To build a power plant often takes between two and five years. Transmission lines take a considerable period of planning before they can be established and perhaps as much as two years to obtain the right-of-way to build them. The total power system cannot be designed until this right-of-way is established.

The market for power will be affected by the existing industry and potential existing markets for various types of goods in the future. Here it is evident that demographic and economic forces in the form of population shifts, and even income shifts, can have an impact on power sales. Governmental factors are also extremely important. Such items as establishing rates, types of governmental control, the kinds of governmental contracts that are placed with business, and rulings on depreciation allowances, all have profound implications.

Technology indeed is a critical consideration. Some forecast must be made of the impact of the development of various sources of power, including the use of atomic reactors and the St. Lawrence Seaway. Moreover, an account must be taken of the competition that will exist during the pertinent future period of time and its impact upon pricing and other market conditions.

There may well be certain ethical, moral, or social considerations. If an atomic reactor is used, there may exist an adverse public climate since people may be unwilling, initially, to accept this type of establishment in the community.

Obviously, such reactions as these could seriously affect the forecast. The importance of recognizing and evaluating what impact non-controllable management factors will have on company operations in this case is self evident. This is merely one example. Numerous others could be cited from such industries as wood products, chemicals, mining, petroleum, transportation, and communications.

The Interior Climate

After having determined this external business climate, an evaluation must also be made of the impact of the internal business factors on potential sales. Management must weigh those factors over which it has direct control. While these internal factors are often fixed or given for a short period of time, they may be adjusted by the company over the longer run.

To forecast effectively, an evaluation must be made of the company's financial situation, management know-how, plant and equipment, material resources, personnel, and the company's reputation, image, and position in the market place. These factors will have a direct bearing on the quantity and quality of sales.

It is the market impact of the internal business factors operating within the external system which will determine the competitive position that is even-

tually earned. An evaluation of both climates, the external and internal, will give some guides which will indicate potential sales opportunity for a company. By applying judgment and using various techniques of analyses to be discussed later, management integrates the external and internal business environments. It evaluates the trends and patterns and combines them into a sales forecast.

By these means, sales forecasting becomes an integrating management tool. It acts as a management link between external and internal business conditions, between the given elements of the total system within which business operates, and the internal limits of the business itself.

There exists another aspect to this perspective of sales forecasting as an integrating management tool. The sales forecast itself is also a means of integrating specific operating programs and targets with potential sales opportunity. This is achieved by translating the sales forecast into specific profit and sales objectives, which are to be achieved through the planned use of company resources. The sales forecast then becomes integrated into the operating aspects of management activity by establishing definite profit and volume goals.

It is as a result of this refinement of the sales forecast that coordinated advertising budgets are established, purchasing plans made, integrated marketing programs designed, financial requirements delimited, personnel needs determined, production schedules planned, plant and equipment requirements established, expansion programs determined, and perhaps most other aspects of management programming activated. Here the sales forecast becomes an integrating tool of management by assisting in the coordination and control of total resources in order to achieve projected goals.

In the bottom portion of Chart I, sales forecasting is portrayed as a vehicle for translating the non-controllable environmental factors and the controllable business environment into specific controllable management objectives and programs. It is evident that sales forecasting becomes a means of planning objectives effectively and organizing and controlling resources to achieve them. It integrates the total operating environment with the company's resources and translates them into realistic objectives. In this perspective we may perceive the sales forecasting program as the integrating element of management activity.

A COMPONENT OF THE INFORMATION PROCESS

To add to our perspective of sales forecasting, it will be considered from another vantage point—from the viewpoint of forecasting as part of the information process. For these purposes, Chart II has been prepared. It is designed to illustrate the role of sales forecasting as an integral component of the process of gathering management information and to relate sales forecasting as a means of assembling information to the total decision-making process.

Intelligent executive decision-making can only function properly if adequate and pertinent information is available as a basis for decisions. At the top of the chart the role of information in the decision-making process is very briefly and sketchily portrayed. This merely indicates that information adds to man-

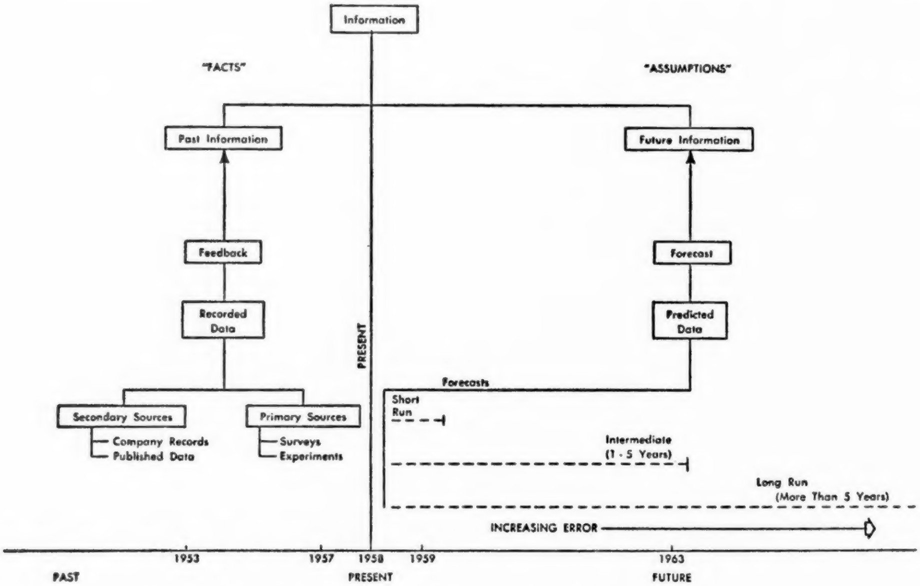

Chart II—Sales Forecasting: A Component of the Information Process

agement knowledge which in turn may temper, add to, and perhaps form the basis for management judgment. It is through the use of executive judgment that decisions are made between the various alternative courses of action concerning all the operating aspects of the firm. These decisions later are translated into company plans, programs, and operating procedures. Therefore, it is evident that good information becomes the basis for effective decision-making, which in turn is the basis for coordinated programming of goal-directed company efforts.

"Facts" and "Assumptions"

Essentially, all management information might arbitrarily be divided into two basic categories. Information can be characterized as pertaining to either the past or the future. In Chart II, an arbitrary line represents the present instant of time. To the left of this line is information about the past, to the right information about the future. Information about past activities is often referred to as "the facts". Information about the future is anything but factual and can better be characterized as assumptions. Future information can only be assembled if one accepts certain assumptions about future conditions and events and makes predictions based on them.

Past information is available to every business operation through its record-keeping processes. It is also available from other secondary sources, such as information reported by university research, governmental data and research conducted by trade associations. It is apparent that past information may also be assembled through the use of

certain primary research tools, for example, surveys and experiments.

Unlike past information, future information cannot be derived from company records, but requires the utilization of predictive processes. While future information cannot be gathered directly from records, yet it has a basis in past information, for it is normally the result of applying certain predictive tools to available data.

Whenever a business is gathering future data, varying degrees of error are bound to exist. Regardless of the forecasting techniques used for predictive purposes and the degree of sophistication achieved, conditions will probably deviate widely from what forecasters assume them to be. Future information then will probably always be somewhat in error.

For effective management, and especially for planning purposes, executives require both of these types of information. It might even be stated that from the decision-making point of view the non-factual type of information (information about the future) is more significant than is the factual (information about the past). This becomes obvious if one considers the fact that decisions made today are actually based on what an executive expects will happen during a future period of time. These decisions can only be implemented at some time in the future. Therefore, basic to improving the effectiveness of the decision-making process, and company planning and coordination, is the improvement of the forecasting process. Only by taking account of what the future climate will be like as explicitly laid down in various types of formal or informal forecasts, is management able to make adequate decisions concerning operating activities during some future period of time.

Feedback and Forecasting

In discussing sales forecasting from the perspective of part of the information process, it can be stated that management gathers information as a result of two complementary processes—feedback and forecasting. Feedback results in reporting back to management information about the effects of operations which have actually occurred. This information is normally referred to as factual. Feedback, then, relates facts about the results of actions which have already been performed. By assembling factual data, management is able to adjust existing operations plans and procedures, thereby improving the effectiveness of the total complex of business activities.

The complementary aspect to feedback from the point of view of future information is that of forecasting. It refers to gathering reasonably accurate information which will furnish a perspective of the future. Through forecasting, management develops a perspective of what conditions will probably be like during some future period of time. By predicting what is likely to happen, management is able to gather future information which is used as a basis for establishing broad company goals, setting more specific future targets, and designing strategies to meet them.

It is future information, or forecasts, which are often used as a basis for the determination of various standards. These standards are then applied to guide and control operations. For example, it is through sales forecasting that various types of volume and profit targets are established which in turn

shape company operations and aid in achieving effective coordination and operation of business activities during some future period.

The Moving Present

Chart II has been placed on a time spectrum. The imaginary line drawn at 1958 represents the present period of time. The chart is designed to indicate that the present is constantly blending into the future. As it does, then the present and the future eventually become the past. The sales forecast, then, which is an estimate of probable future sales, will eventually take the form of feedback information. Once it does, a comparison may be made between forecast sales and actual sales for a period. Through this process, deviations can be noted and explanations for them sought. Such information can then be used for refining assumptions about the future and increasing the effectiveness of the total forecasting procedure.

The types of predictions which are made may be short-run sales forecasts, which have sometimes been defined as forecasts of less than a year; intermediate sales forecasts, which have been defined as being no more than perhaps three or, at the most, five years; and long-run sales forecasts, which are for longer periods. Since forecasting error generally tends to increase directly with the period of time covered, long-run sales forecasts tend to have greater errors than do intermediate ones which, in turn, generally have greater errors than short-run forecasts.

As a component of the information process, sales forecasting provides a statement of future conditions that are likely to hold during some definite period of time. Along with the companion information tool of feedback, forecasting holds an important and significant place in the overall planning, organization, and control functions of the individual firm. Sales forecasting is an essential part of an effective decision-making process within the business enterprise. It is in this context, as part of the information process, that sales forecasting becomes a means of improving the overall functioning of company activity.

AN EFFECTIVE PROGRAM

Another perspective of sales forecasting may be gained by examining various elements of a comprehensive forecasting program. Table A sets forth, in sequence, the procedures that should be undertaken, the techniques that may be utilized during each step, and the results that should be achieved by such a program.

If this table is compared with Chart I, it will become evident that it starts with the same non-controllable business environment, and works down to various predictions about controllable business plans and programs. Table A develops in detail the means by which forecasting becomes an integrating tool of management.

The Information

The first step in a comprehensive sales forecasting program is to gain knowledge about non-controllable and partially-controllable business factors, the elements of the external business environment. A listing is made of the external factors: cultural, social and economic climates, competitive forces, demographic environment, ethical, international, and technological factors.

TABLE A

ELEMENTS OF AN EFFECTIVE FORECASTING PROGRAM

Procedures	Techniques	Results
1. Recognize Non-controllable Business Environment.	Observe and list significant external factors.	Identification of pertinent cultural, social, economic, political, demographic, competitive, ethical, international, technological forces.
2. Gather information about non-controllable forces.	Investigate outside sources of information.	Selection and gathering of data from government, industry, university research, Federal Reserve Board.
3. Gather information about controllable forces.	Investigate company records.	Selection of relevant company forecasting information.
4. Analyze data.	Apply analytical tools: time series analysis, least-squares, simple correlation, multiple correlation, input-output tables, breakeven charts.	Determination of patterns and relationships: lead and lag indicators, cycles, seasonal indexes, trend lines, covariation.
5. Forecast future sales.	Employ extrapolation, constant per cent increase, end-use analysis, executive opinion, historical analogy, panel of experts, grass roots, surveys, models, experiments, samples, hunches, judgment, and crystal ball.	Prediction and definition of future dollar sales, unit sales, maximum and minimum ranges.
6. Refine sales forecast.	Break sales down by volume and profit control units: product lines, territories, customers, salesmen.	Establishment of specific sales targets.
7. Translate specific targets into operational programs.	Establish and coordinate plans: marketing program, production schedules, purchasing plans, financial requirements, personnel needs, plant expansion, capital equipment budgets, inventory levels.	Identification of controllable business environment.
8. Review forecast.	Audit relationships between actual and forecast sales.	More accurate sales forecasting.

Next there is need for information about all of the relevant elements, so that the framework within which business must operate may be adequately identified. To accomplish this, outside sources of information must be used. Data are gathered from governmental sources, industry or association sources, university research, the Federal Reserve Board, and from other types of records.

Next it is necessary to gather information about controllable business forces. This information about the internal business environment may be obtained from company records. The relevant data are selected and reclassified.

The Analysis

To this total body of information which has been gathered the forecaster must then apply basic tools of analysis. These include time series analyses, fitting lines by the least-

squares method, determining covariation by simple and multiple correlation, development of input-output tables, and break-even charts. The purpose of applying these analytical tools to the types of information gathered is to determine whether specific patterns and relationships seem to exist. The forecaster tries to identify trend lines, seasonal indexes, lead and lag indicators, various cycles, and measures of covariations. Using these relationships as a base, an attempt is made to predict future sales.

The techniques used in this stage of actually forecasting sales range from "somewhat scientific" to absolutely "non-scientific," from the mathematical to the crystal ball types. Among the common techniques being utilized are methods of extrapolation, straight percentage increase, end-use analysis, models, experiments, surveys, grass roots approach, executive opinions, hunches and judgment. The result of the application of these techniques is the prediction and definition of future sales. Sales forecasts are stated in terms of dollars or units or a maximum and minimum range.

At this stage the sales forecast has actually been made. However, to use it for decision-making purposes further refinement is necessary, since the mere statement of the total overall projected figure does not suffice. The next task, therefore, is to break down these figures into smaller units which are more meaningful in terms of both volume and profit controls. Sales are forecast by such control units as product lines, territories, customers, and salesmen. The specific sales targets thus established may be stated in terms of each of the many elements of the total product mix or in terms of specific types of goals to be achieved within territories or by specifying the types of customers to be contacted or sales to be made.

Thus the total sales forecasting process is one of refinement. It starts with the more general factors, the external non-controllable environment, and works down to operational goals and specific types of targets.

The Program

Carrying this refinement process still further, the next step is to translate the specific targets which have been established into actual operating programs. The procedure here becomes that of establishing and coordinating various types of plans and programs. For example, the marketing program is developed, production schedules are established, purchasing plans are determined, financial requirements are specified, personal needs are outlined, plans for plant expansion are drawn up, capital equipment needs are specified, various types of budgets are established, and inventory levels are set. This, of course, results in the identification of the controllable business environment.

The Review

The last step in a comprehensive forecasting program is that of reviewing the forecasting results and procedures. It requires an audit of the relationship between actual and forecast sales to determine the accuracy of forecasts and devise methods for improving them. Here it is necessary to note deviations and to determine reasons for them. Then attempts can be made to sharpen up the tools and techniques used so that the discrepancies may be reduced in future sales forecasts.

Empirical evidence concerning the

forecasting programs of various companies shows that companies having a sales forecasting program for a considerable period of time are able to predict with greater degrees of accuracy than those companies that have not. Part of the reason for this is attributed to the opportunity to apply this last step of review over a longer period of time and to make various corrections and adjustments in procedure.

By using the accepted techniques specified in each of the sequential steps of the sales forecasting program, the external business environment becomes translated into controllable management programs. The functions of planning, organizing, and actually controlling business operations to achieve realistic goals are carried out more effectively and company resources are coordinated to achieve greater impact in the market place. It is in this way that the total forecasting program becomes one of the significant means for increasing a company's sales and profit position.

Management often inadvertently avoids engaging in effective forecasting programs and developing more efficient forecasting techniques. This is especially the case where long-run forecasting is concerned. One of the greatest inducements to ignore or neglect sales forecasting is the difficulty which is encountered in making predictions.

It is no easy or comfortable task for anyone to ponder the indefinite future, to try to establish the relationships of patterns which exist in economic and company data, and to arrive at some realistic estimate of future sales. It is much easier and far more comfortable to turn to the consideration of current operating problems which have more concreteness about them, are simpler to grasp, for which immediate programs may be instituted and about which something definite can be done.

Yet professional management today is concerned with the development of well-planned, coordinated and forceful systems of business action. It is charged with organizing goal-directed efforts for all company resources so that the firm may entrench itself in the market-place, grow, and earn its due returns. The perspective to be faced by future executive management is one of an increasing degree of competition, an exhilarating pace of technological change, a heavier burden of fixed costs, and an ever more dynamic market-place. A major problem, therefore, becomes one of adapting the total complex of company activity to a constantly changing market environment. It is in such a situation that comprehensive planning becomes the core or foundation for effective management.

As Ralph J. Cordiner has stated ("Breakthrough to the Future," *The Management Review*, August 1956, P. 672.),

> In a time of radical world-wide change, when every day introduces new elements of uncertainty, forward planning may seem to be nearly impossible—an exercise in futility. Yet there never was a more urgent need for long-range planning on the part of every business.

It seems likely, therefore, that one of the future developments in management affairs will be a much greater stress on the role of planning to maintain and extend a company's market position. Since sales forecasting is one of the primary steps in realistic company planning, it is to be expected that an increasing amount of time and resources will be spent in developing more effective techniques for sales forecasting.

CHARLES J. GAA

Federal Income Tax Modifications in 1958

Highlights of change affecting business and the individual

Legislation passed in 1958 affecting taxes was substantial. It included: the Technical Amendments Act of 1958 ("Mills Bill"); the Small Business Tax Revision Act of 1958, and several separate small acts, which in the aggregate represent a fairly large volume of changes.

In addition, modifications were made in the social security system, the estate tax, and excise taxes. Since the volume of changes was very large, it is not feasible to attempt to explain all of them or to go into much detail about many of them in this article. Consequently, only some of the most important, the most commonly used, and the most interesting changes are discussed.

Although January 1, 1954, August 17, 1954, January 1, 1958, and September 3, 1958 appear to be the most common effective dates for the new provisions, several other dates are specified for particular amendments. Refunds will be in order in some instances because of the retroactive applicability of some of the amendments.

INDIVIDUALS — PERSONAL

Individual income tax rates remain unchanged in 1958.

Limitation on Medical Expense Deduction (IRC 213)

The maximum limit on the medical expense deduction has been liberalized for all persons who are at least 65 years old *and* are disabled, as defined by the law, at the end of the taxable year or at the date of death of the disabled person.

If one spouse qualifies, the maximum for him is $15,000. If both spouses qualify, the maximum is $15,000 for each, a total of $30,000 in a joint return. Even if both qualify, the limit is not aggregated; each spouse is limited to $15,000. For example: assume both spouses qualify and $20,000 is paid for the husband's medical expenses and $6,000 for those of the wife. The maximum deduction is $21,000 ($15,000 for the husband and $6,000 for the wife). The medical expenses of the nonqualifying spouse and of dependents follow the old general rule ($2,500 x number of exemptions [excluding those for old age and blindness] in the tax return, to the maximum amount of $5,000 in a separate return and $10,000 in a joint return). For illustration; assume only the husband qualifies; there are no dependents; $9,000 is spent for the husband's expenses and $7,000 for those of the

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DR. GAA *is professor of Business Administration, MSU.*

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Nonbusiness Bad Debts (IRC 166)

The distinction between a "nonbusiness" and a "business" bad debt is important. The former is treated as a short-term capital loss; the latter is considered to be an ordinary deduction. IRC 166 has been amended to make it clear that "business" bad debts are only those created or acquired in the taxpayer's trade or business. For example: a debt received by inheritance or gift from a donor who may have received it in connection with his business is not a business bad debt to the heir or donee. (Effective retroactively for the entire period covered by the 1954 Internal Revenue Code.)

Medical and Dental Expenses of a Decedent (IRC 213)

Expenses of a decedent paid by the estate within one year after death are treated as though paid by the taxpayer at the time incurred. A statement must be filed saying that such amounts have not been *allowed* and are waived for estate tax purposes. Formerly, the statement had to show that the amount was not *claimed* for estate tax purposes.

Dependents (IRC 152)

Portions of the definition of a "dependent" have been changed. It is made clear that a spouse is not a dependent. A person living illegally with the taxpayer is not a dependent; for example, a common-law wife in some states. A legally adopted nonresident alien child may be treated as a dependent of a citizen of the United States if the taxpayer's home is the principal abode of that child and the child is a member of the household.
(The latter provision is effective for tax years starting after 1957; the other two are effective retroactively for all years covered by the 1954 Code.)

Education Expenses (Reg. 1.162-5)

Expenses incurred for refresher or other education of teachers, professional people, and others are deductible under more liberal rules than they formerly were. The fact that the expenses were incurred voluntarily, that the courses carry credit, or that they result in improvement in rank or salary does not require disallowance. Since this regulation was made retroactive for years covered by the 1954 Code, refund claims may be made.

Gross Income Test for Filing Tax Returns (IRC 6012)

The general rule is that a taxpayer who has at least $600 ($1,200 if age 65 or more) of gross income must file a tax return. Usually "gross income" excludes exempt income. However, taxpayers now must include in gross income *for this test only* any tax-exempt earned income derived from outside of the United States. This change is intended to improve the administration of tax returns filed by taxpayers with foreign earned income and *does not subject such income to tax.* A new Form 2555 (Statement To Support Exclusion Of Income Earned Abroad) must be attached to the taxpayer's Form 1040 if he has tax-exempt earned income from foreign sources.
(Effective after December 31, 1957.)

Basis of Gift Property (IRC 1015, 2501)

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(Effective after December 31, 1957.)

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The basis of property shall include the amount of gift taxes paid by the

donor or donee upon its transfer. This increase may not cause the basis to exceed the fair market value at the date of the gift for gifts made on or after September 2, 1958. For gifts received before September 2, 1958 and held on that date, the basis shall be increased on September 2, 1958 by the amount of the gift tax. However, this increase is limited to the excess of the fair market value at the time of the gift over the donor's basis at the time of the gift. The gift tax paid in any calendar year is prorated over all taxable gifts made in that year.

Condemnation of a Residence (IRC 1033, 1034)

The involuntary conversion rule for condemnations explained on page 56 for business property also applies to a personal residence. In addition, a taxpayer may apply either (a) the rules for nonrecognized gain on involuntary conversion or (b) those for nonrecognized gain on sales or exchanges to a condemnation of a residence. This provision is effective for condemnations after December 31, 1957.

Loss on Small Business Stock (IRC 165, 1244)

Ordinary loss results up to $25,000 ($50,000 in a joint return; whether the stock is owned by one or both spouses) to an individual taxpayer or partnership to whom small business stock was originally issued, when such taxpayer disposes of it at a loss or it becomes worthless. Stock issued to a partnership and subsequently distributed by it to the partners does not qualify; this special treatment applies only to the individual or partnership to whom the stock was originally issued. This provision does not apply to trusts, estates, corporations, or transferees of the shares from the original purchaser. New IRC Section 1244 contains criteria regarding (a) the type of stock which qualifies and (b) the nature of "small business corporations" which are covered by this provision.

The amendment covers common stock only; it does not extend ordinary loss treatment to losses on loans, which probably are to be considered to be nonbusiness bad debts and to be subjected to short-term capital loss treatment. Consequently, in capitalizing a corporation the advantages of issuing capital stock which is eligible for IRC 1244 will have to be weighed against a contribution of capital in the nature of a loan which will result in an interest deduction for the corporation.

Loss in excess of $25,000 (or $50,000) is subject to capital loss provisions. The ordinary loss portion is a business loss for the net operating loss deduction.

PROPRIETORSHIPS - PARTNERSHIPS

Election to be Taxed as a Corporation (IRC 1361)

The law has been amended in so far as it touches on revocation of the election of certain proprietorships and partnerships to be taxed as corporations. The election may be revoked within a period of three months after final regulations for IRC 1361 are released by the Treasury Department. Such revocation will have retroactive application to all years for which the election was made.

Loss on Small Business Stock (IRC 165, 1244)

Individuals and partnerships may treat a loss up to $25,000 as ordinary loss rather than as capital loss upon the

sale exchange or worthlessness of such stock. (See a more detailed discussion on page 54.)

CORPORATIONS

Tax Rates

Corporation tax rates were not changed for 1958; however, the 30% normal tax on the first $25,000 of income will drop to 25% for taxable years starting after June 30, 1959. The 22% surtax will continue. Corporations whose taxable years overlap this date will have to prorate their tax computation, using the old rate for the period on and before June 30 and the new rate for the time after June 30. There were no changes in the rates for the additional taxes on personal holding companies and on improperly accumulated earnings of corporations.

Deduction for Dividends Received (IRC 246)

The special deduction is denied for dividends on stock sold before it has been held at least 15 days.

The amendment requires that the full dividend be reported without reduction for the 85% dividends received deduction. Before the amendment, the dividend was taxed at a maximum of 7.8% (for example: 52% corporate rate × [$100 dividend—$85 dividend received deduction] = $7.80 tax).

Further, to get the dividend received deduction if the dividends are those in arrears on cumulative preferred stock, the stock must be held at least 91 days if more than 366 days' dividends are received. The amendments also cover some other situations in which the dividends received deduction will not be allowed.

(Effective for years ending after 1957 and for stock acquired after 1957.)

Penalty Tax on Unreasonable Accumulations of Income (IRC 535, 1551)

The minimum accumulated earnings credit which reduces the base against which the penalty tax rates are applied has been increased from $60,000 to $100,000 for taxable years starting after 1957. Of course, earnings above this level may be retained without penalty if they are reasonable in view of the needs of the business. A taxpayer might consider multiplying the accumulation of penalty-free earnings by the formation of separate corporations for distinctly separate new enterprises or activities. Although this provision was intended primarily to benefit small businesses, it may be used by all corporations, regardless of size.

"Partnership" Treatment for Small Business Corporations (Subchapter S, IRC 1371-1377)

A "small business corporation" may elect not to be taxed on its income as a corporation. If the corporation elects this option, the shareholders include in their tax returns their prorata shares of the corporation's income for the taxable year, whether it is or is not distributed. Undistributed income on which the shareholder has been taxed will not be taxed a second time when it is subsequently distributed. The basis of a shareholder's stock is increased by taxed but undistributed income and is reduced for income distributed at a subsequent date and not taxed.

The shareholders are allowed neither a dividend exclusion nor a dividends received credit, nor may they use the income in computing the retirement income credit. The income of the corporation loses its identity in the hands of the

shareholders and is treated as ordinary income (in the same fashion as dividends received). *Long-term capital gains are an important exception* and retain special characteristics and treatment in the shareholders' returns.

The corporation has no carryover or carryback of net operating loss to or from a year in which the election is in effect. The shareholders' shares of such losses are treated in the same way as those from a partnership or proprietorship and may result in carryback or carryover in the shareholders' returns. Corporate losses passed to the shareholders reduce first the basis of their shareholdings (but not below zero) and then the basis of any debts owed to them by the corporation (but not below zero).

To be eligible, the corporation must be a domestic corporation, not be eligible to file a consolidated return with another corporation, not have over ten shareholders, have only individuals (or estates) as shareholders, not have nonresident alien shareholders, not have more than one class of shares (the IRS says that voting and nonvoting common shares are two classes), obtain the consent to the election from all shareholders of record on a certain date.

The election may be terminated in several ways outlined in the amendment. If this is done, the corporation or its successor must wait five years before again electing to be taxed in this special fashion.

The number of complex problems associated with this optional tax treatment require that it be studied and considered carefully before it is elected. It might be advantageous for an existing partnership or proprietorship to incorporate. Its income could escape the corporation tax rates, while it obtains other advantages peculiar to corporations. However, a small business corporation (because of the small number of shareholders) must be careful to avoid the pitfall of being treated as a personal holding company and of being subjected to a special tax on undistributed income.

The deadlines for elections for calendar years 1958 and 1959 have passed. However, a new corporation incorporated after January 1 may elect the option in the first month of its first tax year.

BUSINESS INCOME — ALL TAXPAYERS

Subdivision of Real Property (IRC 1237)

This amendment specifies that capital gain treatment for subdivided property shall not apply in cases in which the property has been held for sale to customers or in which it is sold in a taxable year within which the taxpayer is a dealer in real estate, whether or not the parcel of property is held for sale to customers.

Gain on Condemnation of Property (IRC 1033, 1034)

The Code provides that no gain is recognized if property is destroyed, stolen, seized, requisitioned, or condemned, provided investment is made in "property similar or related in service or use" or in obtaining 80% control of a corporation which owns such property. This phrase, "related in service or use" has been held to be more restrictive than the provision for investment in property of "like kind" which is used in connection with nonrecognized gains or exchanges of property held for productive use in trade or business or for investment. This amendment permits the "like kind" test to be applied to condem-

nations of real property. It does not extend, however, to investment of the proceeds of conversion into the purchase of capital stock of a corporation which owns such property.
(Effective for condemnations after December 31, 1957.)

Bonds Issued at a Discount (IRC 1232)

This loophole-plugging amendment requires that all of the original issue discount be treated as ordinary income if when the bonds were issued it was the intent to issue them at an extra large discount and to call them at par before maturity in order to give the corporation an ordinary deduction and the bondholders a capital gain to the extent of the unamortized discount. This rule is effective for dispositions after 1957.

Bonds Issued with Coupons Detached (IRC 1232)

Any gain on the disposition of a bond purchased after 1957 is ordinary income to the extent it is attributable to future coupons which were detached when the bond was acquired. Formerly capital gain treatment was allowed to the extent of detached coupons due within twelve months of the acquisition of the bonds.

Lump-Sum Damage Award (IRC 1306, 1307)

Treble damage awards and settlements received in actions under the antitrust laws may be spread back in equal monthly installments over the period within which the damages were sustained, if the result is to reduce income tax below that which would result if the entire award were included in the year accrued or received. The tax is paid as tax of the current year, although it is computed in part in terms of the tax returns of prior years. The approach is similar to that of IRC 1301-1303 which has been in effect for some years for lump-sum receipts of compensation for services performed, income from artistic work, and back pay attributable to prior years.
(Effective for taxable years ending after September 2, 1958, and applicable only to amounts received after September 2 for awards and settlements after that date.)

BUSINESS DEDUCTIONS— ALL TAXPAYERS

Accrued Vacation Pay (IRC —)

For taxable years ending before January 1, 1959, the employer has been permitted to accrue the deduction if all events necessary to fix the liability for vacation pay have occurred before the date of accrual. The Internal Revenue Service has ruled that for taxable years ending after December 31, 1958 vacation pay may be accrued only if (a) there is a liability for a specific employee, (b) the amount of liability to each person can be computed with substantial accuracy, and (c) the employee's rights to such pay are vested at the time of the accrual.

The 1958 change postpones the effective date of the change of rule from December 31, 1958 to December 31, 1960.

Subcontract Price Redetermination (IRC 1482)

Repayments made following price redetermination in statutory renegotiation cases reduce tax of the payer and increase that of the recipient for the year for which payment was made. Recomputation of tax for a prior year or years must be made.
(Effective for subcontracts entered into after December 31, 1957.)

Net Operating Loss Carryback (IRC 172)

Every few years Congress becomes generous and extends the averaging period for net operating loss. For taxable years ending after 1957, the carryback is three years instead of two; the five-year carryover has not been altered. Only a prorata part of a net operating loss for a fiscal year ending in 1958 may be carried back to the third preceding year.

Losses on Stock of "Small Business Investment Companies" (IRC 165, 243, 246, 1242, 1243); Losses on Stock of Investors in "Small Business Investment Company Stock"

"Small business investment companies" have been authorized to provide capital to small business concerns through the purchase of convertible debentures. They are privately-owned companies with paid-in capital and surplus of at least $300,000. These investment companies may take an ordinary loss deduction for losses on sales or worthlessness of their investments in such convertible debentures or the stock resulting from the conversion. Also, they may take a 100% (instead of 85%) dividends received deduction for dividends from small domestic companies.

Purchasers of "small business investment company stock" may take an ordinary deduction for loss from worthlessness or sale of such stock, rather than a capital loss, as is done generally when an investment in capital stock results in a loss. The loss is considered a trade or business loss for the net operating loss deduction.

(Effective for taxable years beginning after September 2, 1958.)

Amortization of Bond Premium (IRC 171)

The rules for amortizing premium on investment in a *wholly taxable bond* acquired after 1957, regardless of issue date, have been tightened up to close the loophole of taking excessive premium amortization as an ordinary deduction, with a resulting gain on the disposition of the bond being taxed at capital gain rates. The amortization is to be determined in terms of the difference between (a) the issue price and the maturity price or (b) the difference between the issue price and the call price, if the resulting amortization would be smaller for the period prior to the call date.

These rules do not apply to bonds issued after January 22, 1951 and acquired between January 22, 1954 and January 1, 1958 if the call date is within three years of the date of issue. For such bonds, amortization must be made over the full period to maturity.

Casualty Loss — Uninsured Business Property (IRC 1231)

Completely uninsured losses from fire, storm, shipwreck, other casualty, or theft of property *used in trade or business or of capital assets held over six months for the production of income* are not to be offset against capital gains. They are *always* to be treated as ordinary losses. This change affects taxable years starting after December 31, 1957 and does *not* apply to losses on partially insured property.

Leasehold Improvements (IRC 178)

The general rule for amortizing the cost of leasehold improvements is to spread it out over the shorter of the useful life of the improvement or the remaining period of the lease. Generally,

in arriving at the period of the lease, renewal periods are included unless the tenant shows that the lease probably will not be renewed. The renewal period will be ignored if the unexpired portion of the lease (without considering any unexercised renewal option) is 60% or more of the useful life of the improvement, unless the lease has been renewed or there is a fair probability that the renewal option will be exercised.

If the tenant and the landlord are related, leasehold improvements may be amortized only over the useful life of the improvement. This amendment is effective for improvements begun after July 28, 1958 but not to those which the tenant is legally obligated to make.

Leaseholds (IRC 178)

A rule similar to that provided for leasehold improvements is followed for amortizing the cost of obtaining a lease. The renewal period will be ignored if at least 75% of the cost is related to the unexpired part of the lease, unless the lease has been renewed or the option to renew probably will be exercised.

Additional First-Year Depreciation (IRC 179)

The "Small Business Tax Revision Act of 1958" provided for additional first-year depreciation and made it available to all business taxpayers (excluding trusts), regardless of their size.

Additional first-year depreciation of 20% of a maximum of the first $10,000 ($20,000 in a joint return) of the cost of *tangible personal property acquired for used in the business of the taxpayer or for the production of income* is allowed in the year the property is acquired.

A partnership may deduct up to $2,000 (20% x $10,000) for each partner who files a separate return and up to $4,000 (20% x $10,000 x 2) for each partner who files a joint return. Presumably, a partner in his own return is limited to $2,000 ($4,000 in a joint return), which includes his share of partnership first-year depreciation as well as any he might have from another business. To illustrate: a firm with five married partners who file joint returns with their spouses may deduct $20,000 [(20% x $10,000 x 2] x 5). This is ten times the amount a corporation with such persons as shareholders could deduct.

A corporation is limited to $2,000 (20% x $10,000), which includes "small business corporations" which elect the option of "partnership" treatment for tax purposes (see page 55). First-year depreciation may be taken by any member of an affiliated group of corporations eligible to file consolidated returns or may be divided among the members of the group; the maximum for the group is $2,000. The amcunt of initial depreciation allocated to an heir, assignee, or devisee of an estate as a life tenant or beneficiary is in addition to any amount to which that person is otherwise entitled.

Initial depreciation is in addition to any other depreciation allowable for the first year under other provisions of the Code. The property must be of a character which is subject to allowance for depreciation in general in order to be entitled to initial depreciation. The 20% is applied against cost *without regard to salvage value.* Ordinary depreciation is then figured on cost reduced by the additional first-year depreciation. Some of the ordinary depreciation methods require that salvage value also be subtracted from the basis of the property

before computing depreciation; others do not. Additional first-year depreciation is allowed for a full year, regardless of the date the property is acquired, so long as regular depreciation is allowable for at least part of the same year. If depreciation in general is not allowed for a small portion of a given year but is postponed to start on the first day of the next year, the initial depreciation is taken for that next year instead of the year of acquisition. This situation might exist, for example, if the property were acquired very late, say December 20 for a calendar year return.

Only *tangible personal property* qualifies; real property such as land and buildings do not. The property may be *new* or *used.* If the property or properties are beyond the $10,000 (or $20,000) limit, the taxpayer may assign the first-year depreciation to the property or properties in the proportion he desires, subject to the maximum limit, of course. The property must have been *acquired after December 31, 1957,* have a *remaining useful value of at least six years* when acquired, and have been *acquired from an unrelated person.*

IRC 267 furnishes the tests for relationship; however, for purposes of initial depreciation, brothers and sisters are not "related". Affiliated companies are related (see IRC 1504 and use 50% instead of 80%).

The amendment states that acquired property is not included if the basis for it is determined in whole or in part by reference to the property in the hands of the person from whom it was acquired or it is acquired (IRC 1014 (a)) from a decedent. Further, the cost of the property does not include so much of the basis of such property as is determined by reference to the basis of other property held at the time by the person acquiring the property. Thus, property acquired by gift from a donor or from a decedent is not covered. That acquired by exchange on a trade-in is covered but only to the extent of cash given when the old property was traded in.

The following example illustrates how initial depreciation is to be taken:

Machinery was purchased on January 1, 1958, for $26,000 by a single taxpayer. It had a useful life of ten years and an estimated salvage value of $3,000. The taxpayer plans to use the straight-line depreciation method. (He could have used another method if he chose to do so.) Depreciation for 1958 is:

Additional first-year depreciation 20% x $10,000)	$2,000
Regular depreciation [10% ($26,000-2000-3,000)]	2,100
	$4,100

The depreciation for subsequent years will be $2,100.

This provision presents several possibilities for tax-minimization. If a taxpayer—for example, a single person—plans to buy $20,000 of equipment late in the year, he might defer the purchase of one-half to the start of the next year and have two $10,000 bases for initial depreciation, one in each of two years (assuming, of course, that the initial depreciation for the second year is not used up by other purchases in that second year).

Shareholders in a closely held corporation might look into the possibility of multiplying the $10,000 base for initial depreciation by buying eligible properties, leasing them to the corporation, and, perhaps, selling them to the corporation in subsequent years.

First-year depreciation is elected by attaching a statement to the return which states that the election is being made and which includes appropriate

information regarding the acquisition and the property involved. The election must be made by the due date of the return (including extensions) and may not be changed without permission. (Effective for tax years ending after June 30, 1958, and to property acquired after December 31, 1957.)

ADMINISTRATION AND MISCELLANEOUS — ALL TAXPAYERS

Foreign Tax Credit (IRC 904, 6611)

The amount of taxes paid or accrued to foreign countries or United States possessions disallowed as a credit against tax because it exceeds the "per country" limitations in the existing Code rules may now be carried back for two years and then forward for five years. The carryover or carryback may be applied to the extent the tax paid or accrued in such other years is below the "per country" limitation for that year.

This rule is effective for taxable years starting after December 31, 1958. No carryback may be made to any taxable year starting before January 1, 1958.

Options to Buy or Sell Property (IRC 1234)

Gain or loss is ordinary gain or loss or capital gain or loss, depending upon the nature of the property which underlies the option. For example, an option to buy or sell a residence results in capital gain if the option is sold or lapses. An option not exercised or sold is deemed to have been sold on the date it expires. This provision does not apply to options acquired before March, 1954 or to (a) dealers, (b) "preferred stock bail-outs", (c) gains deemed to be taxable dividends, (d) gains in the nature of compensation, and (e) other situations in which gain is regarded as ordinary income without reference to IRC 1234.

Change in Accounting Method (IRC 381, 481)

The Code requires a taxpayer who *voluntarily* changes his method of accounting to make appropriate adjustments for years covered by the 1954 Code to avoid duplication or omission of incomes or deductions. This amendment requires adjustments for earlier years if the change in method occurred in a year covered by the 1954 Code. If net income from such adjustments exceeds $3,000 it may be spread over a ten-year period starting with the year of change, if the change is made in a year starting before 1964. However, there are some circumstances under which this rule does not apply.

If the taxpayer so elects within a six-months period after September 2, 1958, he may return to his old accounting method if he voluntarily changed for a year which ended before September 2, 1958.

Timely Filing of Information Returns (IRC 6652(a))

Not only must information returns be filed under existing law, but as the law has been clarified, they must be filed on time unless there is reasonable cause for delay. Such information returns include, among others, payment of dividends and withholding of income tax.

Refund Claims (IRC 6511)

A claim for refund may be filed by the later of (a) three years from the date the return was *actually filed* or (b) two years from the date of payment. This change represents a liberalization of the old rule which provided for the later of (a) three years from the *due date or* (b) two years from the date of

payment. The change extends the refund period in cases in which an extension of time for filing has been granted and makes it the same as the period for assessment of additional tax by the Internal Revenue Service.

The refund period for an individual's net operating loss carryback was increased one month to the 15th day of the 40th month after the end of the taxable year of net operating loss.

Other Changes

IRC 6601 (computation of interest on underpayment of tax) and IRC 7502 (c) (the option of using "certified mail" as well as "registered mail") were liberalized. IRC 7215 and 7512 were tightened up on employers' collection and payment to the IRS of income and social security taxes withheld from employees.

In ordinary politics it must be admitted that the gift of public speaking is of more decisive value than anything else. If a man is fluent, dexterous and ready to go to the platform, he possesses the one indispensable requisite for statesmanship; if in addition he has the gift of moving deeply the emotion of his hearers, his capacity for guiding the infinite complexities of national life becomes undeniable. Experience has shown that no exceptional degree of any other capacity is necessary to make a successful leader. There need be no specially arduous training, no great weight of knowledge either of affairs or the human heart, no receptiveness to new ideas, no outlook on reality.

Wilfred Trotter, in *Instincts of the Herd in Peace and War* (London, T. F. Unwin, 1916)

PETER HENLE

Price Movements in Recent Years

An analysis of the contention that inflation is the product of a wage-price spiral

The heading of an advertisement by an investment advisory service, August 31, 1958, reads as follows:

SIX STOCKS TO MEET MORE WAGE INFLATION
Investments to Protect Your Capital and Profit from Wage-Price Spiral

This emphasis on "wage inflation" illustrates the extent to which organized labor has been made responsible for the nation's steadily rising price level for the past two years.

Such matter-of-fact use of the term "wage inflation" could never have been achieved without the veritable barrage that has been leveled in recent months at the wage policies of organized labor. Newspaper editorials, private research groups, and even some eminent economists, as well as anti-union employer groups, have joined in spreading alarm about the power of organized labor to force "inflationary" wage increases into the economy.

All this barrage has helped the nation's preoccupation with inflation to reach new heights. Almost every month bold headlines portray the economy on the brink of disaster as the Consumer Price Index reaches a new high. The size of the headline does not seem to vary whether the index actually records a significant rise or whether it merely nudges up one or two tenths of a percent. In either case, the diagnosis is simply "inflation." Normally, in economic terms the word has been reserved for quite serious situations in which prices are increasing rapidly with a consequent sharp decline in the value of money. More recently, the meaning of the term seems to have changed to connote any type of a general price increase, even a quite gradual one.

In all this publicity, the labor unions have been receiving the lion's share of the blame for the price increases. As one example, consider the replies received by the Senate Finance Committee to a questionnaire circulated among selected businessmen, bankers, and professional economists.[1] One of the questions read as follows:

Beginning in August 1956 there was an increase in the Consumer Price Index each month through September 1957, thereby causing a decline in the value of the dollar. What factors contributed most to this decline in the value of the dollar?

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Not everyone answered this question, either directly or indirectly, but of the 48 who did, 40 laid major stress on rising wage costs, sometimes in conjunction with other factors, but more frequently as the prime cause. Twenty-two stressed the direct responsibility of "powerful labor unions" in causing the "wage-push" inflation. Bankers, corporation heads, and trade association executives were almost unanimous in pointing the finger at labor unions. Professional economists were somewhat more divided.

This paper will attempt to weigh the merits of this attack on organized labor in the light of the price and wage developments since World War II. The period chosen for analysis of price developments is the 12-year period June 1946-June 1958. Although somewhat more recent price information is available, on the whole prices have risen only slowly since June 1958; and because of seasonal variations, it seems best to consider an even 12-year period.

For June 1946, the index number for the Consumer Price Index is 79.8 (1947-49 = 100). For June 1958, it is 123.7. Thus in this 12-year period consumer prices have risen 55 percent, an average of 3.7 percent compounded annually.

While this is hardly a record of price stability, it should be noted that an annual increase of 3.7 percent is a far better record than that compiled during the same period by the economies of practically all other countries. In fact, an international comparison of price changes between 1947 and 1957 shows that the annual rate at which the value of money has depreciated in the United States is lower than in 21 of the 24 nations being compared. The criterion was each country's index of consumer prices.[2]

However, the more advanced U.S. economy is expected to compile a better record on this score than other countries. Having performed well in an international comparison can be no excuse for the failure to take steps to achieve an even better record of price stability.

PRICE CHANGES, 1946-1958

What then have been the basic reasons for this postwar price rise? As a start toward answering this question it is important to recognize that this postwar price increase has not occurred steadily over this 12-year period. Instead, the increases have been concentrated in three relatively short periods of time.

1. In the two years from June 1946 to June 1948, the index rose 23.3 points.
2. In the one year from June 1950 to June 1951, the index rose 9.0 points.
3. In the two years from March 1956 to March 1958, the index rose 8.6 points.

Thus in these three periods covering less than half the 12-year period, the index rose a total of 40.9 points, or 93 percent of the entire postwar rise. For more than half the postwar period, in other words, the price level has been relatively stable.

A more specific analysis of price changes must focus on the economic circumstances that prevailed during these three periods of sharply rising prices. Each of them needs to be examined separately.

June 1946-June 1948

In June 1946 price controls were lifted. The war had been over less than a year, but the reconversion period had proved less troublesome than expected. Employment was high, and most fami-

lies had relatively large purchasing power available because of the savings they had accumulated during the war years. Price controls and other governmental regulations which had proved relatively successful during the wartime period were becoming harder to enforce.

Since such civilian goods as autos, appliances, etc., were just beginning to come on the market in quantity, there was a tremendous demand for them. Consumers were ready and willing to use their available cash to make these purchases. Similarly, business firms anxious to achieve maximum production were interested in obtaining scarce materials and parts as quickly as possible.

When price controls were lifted, the result was scarcely unexpected. Consumers and business firms with available resources quickly created a heavy demand for goods, thus developing a favorable opportunity for prices to rise. It was a classic example of how a heavy demand for goods pressing upon a limited supply can lead to a general price increase. The rise in prices was quite spectacular in the last half of 1946, but slowed somewat during 1947 and 1948 as the shortages were overcome and as the postwar boom began to lose its force.

June 1950-June 1951

By June 1948 prices became more stabilized and eventually dropped slightly as the nation's first postwar recession got underway. By the spring of 1950, the nation was pulling out of the 1949 recession when the Soviet puppet regime of North Korea crossed the boundary line and invaded South Korea. In addition to setting off an international crisis, the development had further repercussions around the globe since business, consumers, and governments all began to buy and stockpile various scarce materials and goods in anticipation of a possible third World War.

The result of this heavily increased demand was a spectacular increase in the prices of raw materials and, to some extent, finished goods. In the United States wage and price stabilization measures eventually became necessary, but these were imposed only after most of the damage was done. By the summer of 1951, when it became clear that the Korean conflict was a localized affair, consumer and business buying abated, and prices began to stabilize.

March 1956-March 1958

Following the stability in prices after the Korean period, prices fluctuated within a relatively narrow range for a period of almost five years. This included the prosperous years of 1952, 1953 and 1955 as well as the recession year of 1954. In fact, during this period, consumer prices rose at a rate of less than one percent a year. But in the spring of 1956 once again the average price level started to rise. Food prices, which during the previous few years had been declining slightly, offsetting price rises in other goods, became more stable while prices of other goods and services led the Consumer Price Index to higher levels.

The increase amounted to 3.7 percent from March 1956 to March 1957 and another 3.7 percent for the following year. Price increases continued to appear even after signs of recession appeared on the horizon. The index has continued to increase since March 1958 but the rate has slowed down considerably, although it is too early to say whether the economy has entered a new period of relative price stability.

It is clear from this review that different factors have characterized the three postwar periods of rising prices. In the immediate postwar period, the shortage of goods and the availability of purchasing power saved up from World War II created the conditions that led to spectacular price increases. In the second period of rising prices, the impact of the Korean war caused scare-buying by both consumers and businessmen that led to higher prices. In these two periods the basic factor leading to higher prices was the pressure of heavy demand on a relatively limited supply of goods. Almost three-fourths of the entire postwar rise in the Consumer Price Index occurred in these two periods of extraordinary demand.

The more recent period, March 1956-March 1958, has proved more puzzling to economists. There has been no general shortage of goods, although the heavy boom in business spending for plant and equipment has caused shortages of particular materials. While this has been a prosperous period, there have been no special external events to cause a period of scare-buying.

MOVEMENT OF CONSUMER PRICES, 1956-1958

Perhaps because they could find no simple key to these recent price increases, some economists have decided that the major factor responsible has been union wage pressure. They have argued that such union pressure is responsible for forcing continually higher wages, that these wage increases have gone beyond the increase in productivity and thus caused businessmen higher costs and forced higher prices. The conclusion from this argument is that action needs to be taken to curb organized labor.

This charge requires careful examination. This paper attempts to provide this in two ways: first, by studying in more detail the specific price changes that occurred during this period, and second, by analyzing the movement of wages, prices, and productivity.

Particular analysis is needed of the specific price increases that occurred from March 1956 to March 1958. If this charge against the unions is correct, it should be possible to document it by discovering that pressure for increasing prices has been most serious in those industries in which unions and union-won wage increases have played a prominent role.

To examine this charge, the price movement of each individual item in the Consumer Price Index has been carefully examined for this two-year period. The normal breakdowns provided by the Bureau of Labor Statistics are not adequate for this purpose since they group under one heading a number of different products or services from diverse industries, having diverse patterns of union organization.

The following table shows a finer breakdown of items in the Consumer Price Index and their price movements for this two-year period.

This table makes possible a closer look at the movement of prices during the past two years. The figures give little support to the contention that the highly unionized industries have been largely responsible for higher living costs. In fact price increases in those industries in which a large proportion of workers are organized into unions and in which collectively bargained wage settlements receive prominent at-

CHANGES IN CONSUMER PRICES

March 1956–March 1958

(Groups listed in order of price increase)

Industry Classification	Weight December 1955	Percent Increase(a)			Percent of total price increase
		1956-58	1957-58	1956-57	
TOTAL INDEX	100.00	7.4	3.82	3.43	100.0
NEWSPAPERS	.99	16.6	14.8	1.5	2.2
SERVICES	14.59	10.0	5.0	4.7	19.9
Labor services	5.03	7.2	3.1	4.0	5.0
Professional services	3.04	6.7	2.6	3.9	2.8
Finance and insurance	2.74	16.0	10.9	6.7	6.0
Amusement	1.61	11.5	6.8	4.4	2.5
Hospital care	1.34	14.1	7.8	5.8	2.6
Miscellaneous (legal, banking, burial)	.83	(b)	(b)	(b)	1.1
FOOD, LIQUOR, TOBACCO	32.91	10.0	6.4	3.5	44.9
Perishable foods	13.68	17.2	13.1	3.8	31.9
Nonperishable foods	8.45	5.3	2.1	3.2	6.1
Food away from home	4.73	7.1	3.4	3.5	4.6
Alcoholic beverages	2.38	3.7	0	3.7	1.2
Tobacco products	1.98	6.4	5.1	1.2	1.7
Beverages	1.69	−2.5	−8.1	6.1	−0.6
GOVERNMENT SERVICES AND TAXES	1.64	9.9	6.6	3.1	2.2
Taxes	1.38	11.6	7.7	3.7	2.2
Government services	.26	0.8	0.8	0	..
OIL, CHEMICALS, RUBBER AND POTTERY PRODUCTS	7.40	6.2	1.1	5.2	6.3
Petroleum and coal products	3.98	4.7	−2.0	6.8	2.5
Chemical products	2.88	8.4	4.8	3.4	3.3
Rubber products	.35	2.9	4.5	−1.5	0.1
Pottery	.19	12.0	3.7	8.1	0.3
METAL PRODUCTS	11.28	5.3	0.7	4.4	8.1
Transport equipment	4.31	11.0	1.3	9.4	6.5
Electrical machinery	3.04	−3.2	−2.5	−0.8	−1.3
Fabricated metal products	2.49	4.7	1.8	2.8	1.6
Miscellaneous manufactured goods	1.44	6.8	4.4	2.3	1.3
(Appliances)		−2.9	−2.2	−0.8	
PUBLIC UTILITIES	4.95	5.3	3.3	1.9	3.6
Water, gas, electricity	2.40	3.4	2.1	1.3	1.1
Transit and railroad fares	1.46	8.8	5.8	2.9	1.8
Communications	1.09	4.9	2.8	2.1	0.7
HOUSING	13.31	4.9	3.0	1.8	8.8
Home purchase	6.08	4.5	3.6	0.9	3.7
Rent	5.89	4.2	2.0	2.1	3.4
Home repairs	.94	11.6	5.0	6.3	1.5
Housing away from home	.40	(b)	(b)	(b)	0.3
TEXTILE MILL PRODUCTS	1.36	2.9	0.3	2.5	0.5
House furnishings	.75	0.4	−0.9	1.4	....
Floor coverings	.55	4.9	1.6	3.2	0.4
Other	.06	15.0	3.6	11.0	0.1
WOOD AND PAPER PRODUCTS	2.40	3.5	0.1	3.4	1.1
APPAREL	9.17	1.9	0	1.9	2.4
Textile	7.82	1.2	−0.3	1.4	1.2
Leather	1.35	6.1	1.4	4.6	1.1

(a) As computed from the individual items in the quarterly index published by the Bureau of Labor Statistics for a subsample of 19 cities. Total index increases, thus computed, differ slightly from those shown by regular monthly series, which were as follows: 1956-58, 7.5%; 1957-58, 3.7%; 1956-57, 3.7%.

(b) Not priced. Price increase for major group imputed to this item.

tention, are significantly lower than in those areas of the economy where unions are either weak or non-existent.

In fact, the items in the Consumer Price Index can be divided roughly in two parts, those in which unions play a prominent role in wage determinations, and those in which unions do not. The following grouping reflects these two categories.[3]

Average prices for the unionized sector increased 5.2 percent during the two-year period, March 1956 - March 1958, while for the non-unionized sector the increase was 11.1 percent.

While the unionized sector comprises 62 percent of the total index, it accounts for only 44 percent of the total price increase.

Surely this comparison is a clear indication that the influence of union-won wage increases has played but a small role in the price movements during this two-year period. Obviously, many other factors have been at work on the pricing process.

PRICE INCREASES BY INDUSTRY GROUPS

A more detailed discussion of the table will bring out the many complex causal factors behind these price increases.

Newspapers

Among the groups listed in the table, the highest percentage increase has taken place in the price of newspapers. While labor costs are certainly one factor in the business of running a newspaper (and this has been included in the unionized sector of the economy), it would appear that the sharp rise in price has been the result of many forces accumulating over a number of years. Newspapers obviously cannot be subject to frequent repricing. There has been a reluctance to move away from the newsstand price of 5c a copy. The price rise over this two-year period came after a three-year period when prices remained almost stable. Thus the sharp price rise has to be viewed as a reaction

Relatively Unionized Section of the Economy	*Relatively Non-unionized Section of the Economy*
Newspapers	Professional Services
Labor Services	Finance and Insurance
Amusement	Hospital Care
Liquor	Miscellaneous Services (legal, banking, burial)
Tobacco	Perishable Foods
Metal Products	Non-perishable Foods
Oil, Chemical, Rubber and Pottery Products	Food away from Home
Public Utilities	Beverages
Housing	Government Services and Taxes
Textile Mill Products	
Wood and Paper Products	
Apparel	

from demand and cost factors that have been accumulating for several years, rather than an indication of special demand or cost pressures in this particular two-year period.

Services

The second highest price increase (10.0 percent) was registered for the category of services. It has become commonplace for economists discussing "wage inflation" to point to the rise in the price of those services, emphasize the importance of labor costs in their pricing, and carry the argument further by blaming wage increases won by organized labor.

However, these services are a very diverse group, including work performed by highly skilled practitioners as well as by unskilled labor. In a number of cases, the element of labor costs in the services is not nearly as important as it has been imagined.

Within the group, the highest price increase has been recorded for finance and insurance charges (16 percent), including mortgage interest, automobile and property insurance, and for hospital care (14.1 percent).

In both these cases, special factors seem to have been at work. The increases in interest rates come from the greater demand for loanable funds during a time of a capital goods boom as well as the government's attempt to stem price rises by raising interest rates. The higher automobile insurance rates are caused at least partly by an increased level of claims and higher repair costs caused by the structural characteristics of the newer model cars.

In the case of hospitals a number of factors seem to be at work. The increase in the figure for hospital care may reflect not only increases in price, but also the more highly skilled technical services and improved equipment required in modern hospitals. The group hospitalization component may reflect the increased extent to which families have to resort to hospital care. While wage and salary costs form a large part of hospital expenses and have increased substantially, part of this increase reflects a higher proportion of skilled workers rather than an increase in wage rates. At the same time, labor unions and other groups using hospital service have sometimes questioned the need for some of the rate increases that have been put into effect.

At any rate, both in the nation's hospitals and in the various finance and insurance institutions, union membership is extremely weak. While there may, of course, be some carry-over effect from union-won increases in other industries, it would nevertheless require extremely tortuous reasoning to argue that the labor unions have been responsible for this sharp increase in the price of these services.

Other services, too, have increased during this two-year period. The rise in professional fees charged by the medical profession can hardly be said to be directly related to the union-won wage increases.

Even in the group labeled "labor services" involving less skilled work, union organization is relatively weak in a number of areas (domestic service and shoe repair, for example). Wages in these industries are among the lowest in the entire economy, and because of a relatively low rate of productivity advance, wage increases might ordinarily be expected to be reflected in higher prices. Yet prices for this group of

services over the two-year period increased less than the average for the index.

Foods

Also registering a 10 percent increase is the food component of the index. Here the largest increases have been recorded by the perishable foods. In fact increases in this sector account for almost one-third of the two-year rise in the index. While union organization may be prominent in handling some of these foods after they leave the farm, certainly, the major influence on prices has been specific crop conditions that have affected the market price for these commodities. The freeze affecting the citrus fruits in Florida and the drought conditions on the Great Plains during this period affecting meat prices have both had a far greater influence on food prices than union organization or wage pressure.

Government and Taxes

Ranked next in terms of price increases (9.9 percent) is the group headed Government and Taxes. The Consumer Price Index does not measure federal or state income taxes, but it does include various state and local taxes including real estate and auto registration fees. These prices have increased quite markedly in the two-year period. Some of this increase may be related to higher wages (not that unions are not a major factor among state and local government employees) but basically the increase has been caused by expanding demands for state and local government services.

Moreover, there is some real doubt whether any index can accurately measure the price increases for government activities. The index does measure the increased payments which the average city worker has to make for local government services. However, if state and local governments have been improving the quantity and the quality of services rendered to the taxpayer, the higher taxes paid reflect not only an increase in price, but also a better product for the taxpayer.

Other Areas

Making up the rest of the table are the numerous product industries in which workers are relatively well organized. While price increases for a few of these items were above the average, increases for the groups of chemical, metal, wood, textile and apparel products generally fell below the increases for foods and services.

It should be noted that increases in the so-called "administered price" areas of the economy (metals, oil, chemicals, etc.) run higher than the more competitive pricing areas (textiles and apparel.) This paper does not attempt to explore the influence of company-administered pricing practices on the price level. Others have examined the extent to which prices in these industries have been raised beyond levels required by demand or increased costs—or the extent to which failure to reduce prices where practical has failed to provide necessary offsets to price advances required in other sectors of the economy. These are certainly important issues, even if the influence of the "administered price" area may seem rather limited in a study of changes in the Consumer Price Index. In fact, the problem is greater than the foregoing table would indicate since the products subject to administered pricing practices (steel, for example) rather than being listed separately as a consumer product,

become important components of other consumer articles.

One of the highest percentage increases has been for new and used cars. This has certainly been an area in which workers have been well organized and in which collective bargaining settlements have received wide publicity. However, this is also an industry in which there has been serious criticism of the price and production policies of the automobile manufacturers. While a detailed discussion of these pricing practices is not possible in this article, it is certainly an open question whether union-won wage increases or corporation pricing and production practices have been responsible for the higher price of automobiles.

Although automobile prices have risen quite sharply, the prices of many products of other industries in which unions have played a prominent role have increased very little. This is particularly true for the apparel industry where prices have increased but two percent over the two-year period. Yet this is an industry in which union organization is very strong, and wages have steadily increased. The answer lies in the more highly competitive nature of the clothing industry, and the question naturally arises whether the prices of other products would behave similarly if a greater degree of competitive pricing could be introduced.

Special mention is required for appliance prices which have actually declined over the two years. Here the influence of the discount store is clearly evident. This is not to say that the introduction of discount houses into the BLS sample automatically lowers the price level for electrical appliances. In fact the prices of new stores added to the index are "linked in" so that the index is not affected by the lower prices in the new store. However, the effect of discount pricing has been to force reductions in appliance prices at such established outlets as department stores, a movement which is reflected in the index. Again, a question arises whether similar savings in distribution costs could be made with regard to other products.

This brief run-down of price changes during the past few years indicates the complex nature of the pricing process. Today's American economy offers an almost bewildering variety of products (and therefore prices) to the American consumer. Specialized factors affect the demand, supply, or both, of different products and services to different degrees.

No attempt has been made here to argue that wages do not represent an element of cost to the firm or that the level of prices is independent of changes in wage rates. What has been shown is that examination of specific price changes over the past two years does not support the charge that union-won wage increases have been a major factor causing higher prices during the past two years.

WAGES, PRICES, PRODUCTIVITY

In discussing price increases in recent years, economists have tended to ignore analysis of specific price changes but have preferred instead a broader discussion of the relative movements of wages, prices, and productivity.

Here the primary basis for economists' concern is the fact that in some recent years the average increase in wages appears to have exceeded the economy's increase in productivity. From this analysis the conclusion has

been drawn that action must be taken (if necessary, by government) to confine wage increases to the increase in the productivity of the economy; otherwise, it has been argued, wage increases above this allowable amount will inevitably force price increases throughout the economy.

In comparing wages with productivity, some observers have simply compared productivity changes with changes in wages or earnings in current dollars. Such a comparison is obviously fallacious because in effect it says that the buying power of a worker's wages must fall with any increase in the price level. No matter what the cause of the price rise (crop conditions, higher demand, international factors), under this approach the worker would be entitled only to raise his money wage by the annual increase in productivity.

A comparison based on real wages is obviously more in line with economic reality since it recognizes that the economy's gain in productivity means *real* gains which are available for distribution over and above any changes in income necessary to offset price movements.

How serious a discrepancy has actually developed between real wages and productivity? The pertinent figures for the postwar period are given in the accompanying table.

To this observer, the single most impressive fact about this table is that for each of the items the postwar increase is roughly of the same magnitude. Unit labor and non-labor payments (Columns 1 and 2) have increased about at the same rate during the postwar period. Since the two shares are roughly equal (one study indicates that labor

INDEXES OF LABOR AND NONLABOR COSTS, PRICES, EMPLOYEE COMPENSATION AND PRODUCTIVITY
1947=100

	Comparison of nonfarm labor and nonlabor payments and prices			Comparison of real earnings and productivity	
Year	Employee compensation per dollar of real product	Nonlabor payments per dollar of real product	Implicit price change of non-farm sector	Average hourly compensation in constant purchasing power(*a*)	Real product per manhour—all persons total private sector
	(1)	(2)	(3)	(4)	(5)
1947	100.0	100.0	100.0	100.0	100.0
1948	106.0	107.4	106.6	101.0	104.9
1949	105.0	112.1	108.1	105.2	107.0
1950	104.9	114.8	109.3	110.1	115.6
1951	112.9	121.0	116.4	110.8	118.1
1952	117.0	120.8	118.6	114.7	121.7
1953	120.6	121.3	120.9	119.4	126.2
1954	121.7	123.2	122.4	123.1	129.0
1955	121.9	126.4	123.9	127.7	133.5
1956	128.1	126.2	127.2	132.8	134.6
1957	133.0	129.9	131.6	135.2	137.0

(*a*) Hourly Compensation includes wages, salaries, and fringe benefits of all non-farm wage and salary earners, including managerial and executive personnel.
Source: *The Relationship of Prices to Economic Stability and Growth.* Joint Economic Committee, March 31, 1958. Table 50 (Revised) p. 697.

payments comprise 56 percent of total price tags),[4] this means that the non-labor part of the price tag including such items as capital consumption allowances, interest payments, rental income, and profits has been creating just about as much pressure on costs and prices as labor costs. The price rise (Column 3) is the net result of the increased payments.

The same point can be made with regard to the movement of real wages and productivity. Real average hourly compensation in constant purchasing power has been increasing roughly at the same rate as the underlying increase in productivity for the entire private sector of the economy. In fact, starting with 1947 the increase in productivity has been ahead of the increase in real hourly compensation throughout the following 10 years.

These figures certainly do not point to any evidence that wage rates or total employee compensation in real terms has been outstripping the economy's productivity gains during the postwar period. It is true that if the period 1955-57 is considered by itself the figures show an increase in unit labor payments somewhat greater than the increase in non-labor payments and prices. Similarly, real average hourly compensation increased slightly more than productivity gains made by the economy. However, other two-year periods could easily be chosen to show the opposite story. The important point is that even with this reversal during the 1955-57 period, productivity gains for the entire postwar period remain higher than the increase in real hourly compensation.

Moreover, the fact that real wage gains slightly outran improvements in productivity for a two-year period does not appear to have had serious effects on the price level. There may have been some additional upward pressure on prices of particular products as a result of this increase in hourly compensation but judging by the previous analysis of specific price changes, other special factors, such as crop conditions, were of even greater importance in causing the Consumer Price Index to rise during this two-year period.

Was it union-won wage increases during this period that caused real wages to advance more rapidly than productivity? As usual, in the American economy, these increases varied considerably depending on the collective bargaining situation faced by individual firms and industries. In a number of manufacturing industries, construction, and transportation, substantial wage increases were negotiated. In other areas of the economy, textiles, for example, unions were able to win only nominal increases. Considering relatively highly unionized sectors of the economy, it is found that for manufacturing, real straight-time hourly earnings increased 5.4 percent from 1955 to 1957. On the basis of average hourly earnings the increase for contract construction is 5.9 percent and for gas and electric utilities 5.7 percent.

The important point is that these increases are roughly equivalent to the average rate at which productivity has been advancing in the postwar period.[5] Unions had every right to expect continued productivity gains at this rate. The discrepancy between movements of wages and productivity during this two-year period thus was not the result of excessive union-won wage rates but rather the result of two years of rela-

tively low productivity increases. From 1955 to 1957 output per manhour for the private economy increased a total of only 3.4 percent,[6] well below its average postwar rate of growth.

While there is much that remains obscure about the manner in which productivity improvements take place, statistics show that the rate of improvement does not maintain a steady course but often fluctuates from year to year. Productivity rates seem to vary with the business cycle and show the greatest vigor during the period of recovery following a recession.

One particular reason why the rate of increase fell so low for 1956-57 was the hiring of large numbers of technical personnel in this period. Eventually the work of this group obviously will help to stimulate productivity but initially the presence of additional numbers of technicians on the payroll would serve, statistically, to depress the rate of productivity advance.

There is every reason to believe that the low rate of productivity compiled from 1955 to 1957 is being reversed at the present time. In fact, preliminary indications are that 1958 will be a year of above average increase in productivity. In all likelihood, the below average productivity rates for 1956 and 1957 do not signal any change in the postwar trend but were simply the results of special conditions that prevailed toward the top and down-swing of the business cycle.

WAGES AND PRODUCTIVITY

Some economists pointing to the 1955-57 data on wages and productivity have argued that government action was needed to assure that wages did not increase more rapidly than the increase in productivity. The implications of this proposal are very broad indeed.

It is certainly true that the concept of productivity has become better known among both management and trade union officials. At the bargaining table, both sides increasingly recognize the important role which productivity plays in making possible increased living standards. In some cases, most notably in the automobile industry, a specific wage increase known as the "improvement factor," based on the longterm rate of productivity improvement, has become part of the collective bargaining agreement.

However, this recognition of productivity at the bargaining table is a far different matter from requiring by government regulation or otherwise that wage increases be tied to increases in productivity. To begin with, it should be noted that there is nothing sacred about the wage-price-productivity relationship prevailing at any one point in time. There is a danger in picking a particular time period from which to measure changes in this relationship and in thus implying that optimum economic relations prevailed during this particular period. It is doubtful whether wage - price - productivity relationships can or ever should be frozen as of a particular period, and certainly there would be considerable disagreement over the choice of any particular period. For the long-run health of the economy, there may well be occasions when these relations should be altered, and when, for example, wages should rise at a higher rate than productivity.

Even granting that some way could be found on the theoretical level to relate wage increases to changes in productivity, how could this principle be

given practical application? Although unions recognize the importance of productivity increases and recognize the limit which they place on real improvements in living standards, it would be difficult, if not impossible, to develop a practical wage-productivity formula which would govern the determination of wage changes. Certainly it would not be possible to relate wages to current changes in productivity, since reliable statistics on productivity are at least six months behind the period to which they refer. Even for long-run indicators, the technique of determining productivity has not reached the point where there is agreement among economists on the proper methods of measurement.

Any formal effort to link directly wages with productivity would run into a host of difficult issues. Would industries and firms with higher than average productivity have the right to claim additional wage increases? If so, what proportion of such excess productivity would such firms and industries be allowed to retain as wage increases? If not, would price reductions be required? What about collective bargaining situations where the union is unable to win increases equivalent to the productivity advance? Would these workers be awarded additional sums? To what extent would other criteria for wage determination, such as maintenance of the buying power of the individual's wage and elimination of inequities, be recognized? In the automobile industry agreements, for example, the "improvement factor" increase is over and above cost of living increases and a variety of fringe benefits.

Any governmental attempt to tie wage increases to productivity would almost certainly lead to a full-scale wage stabilization program. If the attempt were limited to particuar industries or collective bargaining situations, knotty questions would inevitably arise involving closely related firms and groups of workers.

Moreover, there should be some hesitation about tampering with the American system of collective bargaining, which, though obviously not perfect, has proved an efficient and democratic mechanism for wage determination. While partisans from both the labor and management sides have been arguing for many years regarding the extent of government intervention in the collective bargaining process, both groups demonstrably prefer the process of mutual accommodation in wage-setting to a system with greater government intervention.

On the whole, collective bargaining has proved flexible to changing economic circumstances. The American system with its emphasis on local or company bargaining rather than national collective bargaining yields a great diversity of wage settlements. In effect, most of the wage bargains have been fashioned with an eye to the specific conditions prevailing in the industry, locality, or firm concerned. Experience in the textile and coal industries, for example, demonstrates how collective bargaining results are affected by economic conditions. The extent to which particular wage settlements have become the pattern for other industries is probably less today than it was 10 years ago.

Of course, it will always be possible for economists to find particular collective bargaining settlements which they feel have increased wages at a higher

rate than productivity. But the positive values of collective bargaining should not be lightly sacrificed. The crucial question is whether the system of collective bargaining — not an isolated case or even groups of cases — persistently produces a condition in which real wage advances as a whole outrun improvements in productivity and for price rises.

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[1]Investigation of the Financial Condition of the United States, Compendium of Comments . . . in Response to the Questionnaire of the Committee on Finance, U. S. Senate, 85th Congress, 2d Session.

[2]The First National City Bank Letter, June 1958, P. 71.

[3]There may be some disagreement regarding the degree of union influence in some of these industries. For example, textile mill products has been listed as "relatively unionized" because collective bargaining settlements are given prominent attention even though the majority of textile plants are not unionized. On the other hand, the processing and distribution of non-perishable foods and beverages is often done by union members, but unions are not normally involved in the preparation of the basic product. Very little change in the price increase recorded for the groups as a whole would result if any items such as these were transferred to the opposite column.

[4]Productivity, Earnings, Costs and Prices in the Private Nonagricultural Sector of the Economy, 1947-56, Bureau of Labor Statistics, May 29, 1957, p. 4.

[5]From 1947 to 1957, output per manhour in the private economy increased at an average annual rate of 3.9 percent based on manhours worked or 3.4 percent based on manhours paid. See Economic Report of the President, January 1958, p. 107.

[6]*The Relationship of Prices to Economic Stability and Growth,* Joint Economic Committee March 31, 1958, Table 3A, p. 687. Note: Productivity increase based on manhours worked; increase based on manhours paid is 2.6 percent.

READING FOR BUSINESS AND PLEASURE[1]

Economic Development and Economic Growth[2]

The increasing emphasis placed on the problems of economic development of mature as well as relatively undeveloped national economies by theoreticians and practitioners alike demands more sophisticated tools of analysis to aid in the formulation of policy for development for both poor and rich countries. The complex variables which contribute to the matrix of economic growth continue to be interesting and elusive aspects of the development process. A general theory of economic development remains to be constructed. But new insights, new tools of analysis, and new concepts of the totality of the development process of national growth may be acquired from two recent additions to the rapidly growing body of literature on economic development.

Meier and Baldwin have produced a very ambitious work. It is a mixture of economic theory and economic history, which wanders afield into areas (such as demography, cultural anthropology and governmental process study) which are non-economic in impact on the making of policy decisions for accelerating development in poor countries, and maintaining development in rich countries. Rethinking economic theory and economic history in terms of development, these authors bravely attempt to establish an analytical framework within which one may discover the vital interconnections among the strategic variables in the process of development. Part I of this book reviews the contributions which classical, Marxian, neo-classical and Keynesian economists have contributed to the theories of economic development, a precise, if somewhat brief analysis of the leading contributors. Part II has the ambitious task of producing a structured history of the more significant forces in international development, emphasizing particularly the growth of a British-dominated international economy through the nineteenth century. Part III, "Accelerating Development in Poor Countries" reviews the basic characteristics of these countries, various obstacles to higher development, and general requirements for advancing the standard of economic activity of these underdeveloped areas. Particularly worthy of comment is the effort of the authors to focus sharply and in detail on the socio-cultural, demographic, natural resource, and financial aspects of these economically inferior countries. The final part of this complex work considers economic development as a policy goal, appraising the economic characteristics and trends in rich countries, discussing briefly the general requirements for maintaining development.

Aside from the formidable scholarship which is a virtue of this book, the realization by the authors of the contributions of many disciplines other than economics to an understanding of the development process gives a breadth

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[1]Gerald W. Meier and Robert E. Baldwin, *Economic Development, Theory, History, Policy.* New York, John Wiley & Sons, Inc., 1957. Pp. xix, 588. $8.50.

[2]Harvey Liebenstein, *Economic Backwardness and Economic Growth.* New York, John Wiley & Sons, Inc., 1957. Pp. ix, 295. $6.75.

of analysis which enriches the literature on this increasingly popular field of study.

Economic Backwardness and Economic Growth presents an integrated and unified theory of the economic development of the world's underdeveloped areas. The author, an accomplished economist-demographer, brings to his work the basic conviction that the characteristics usually found in densely populated underdeveloped economies are part of a pattern, and that they generally help to reinforce each other. Thus the simultaneous concurrence of these vital conditions can be best understood in terms of the "quasi-equilibrium" that underlies the state of economic backwardness. This determinism, this semi-mechanical framework for explaining the conditions of underdeveloped areas, permeates the study and is germaine to the conclusions reached by the author as to the investment policy which can correct these defective conditions.

Liebenstein's conceptual framework in this ambitious study has been reinforced by mathematical models which defend many of the well-defined assumptions of economic theory pursuant upon the problems of growth agents and growth activities, production theory and specialization, wage-productivity relationship, and institutional rigidities which operate to produce the quasi-equilibrium previously referred to. Enriching these analytical approaches is the emphasis given by the author to the population variable, an emphasis that places it in the role of an endogenous factor of prime importance in the contributions made by all variables to economic backwardness. Following through, Liebenstein constructs for his analysis a comprehensive economic theory of population growth. This theory is open to considerable criticism for its rigidly mechanistic bias and its lack of appreciation of the non-economic factors of population growth and magnitudes.

Despite this defect, this work is fascinating in its curiosity and its determination to search through the demonstrable characteristics of underdeveloped economies, in its ambition to sketch a general theory for development policy, and in its etching more clearly the demographic factors which are too often considered ancillary to economic development rather than intrinsic. The defects that are further evident, a refusal of the author to come to grips with values which a society may express in terms which are non-economic, and which, when analyzed, are quite important to the stage of economic growth, do not vitiate this work. They only serve to caution the reader against complacency that the last word has been written on this dynamic, complex problem.

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And Mark an Era[1]

The title *And Mark an Era* is from a 1907 letter from Professor Lowell to Professor Tausig, ". . . I think we might make a great success, and mark an era for education for business". Lowell was referring to the establishment of a graduate school of business administration at Harvard. The author of this book about the development of the graduate school is one of its most distinguished teachers, uniquely qualified to comment on the plans, hopes, attitudes and problems of the early years of the school's history.

The purpose of the book, identified in the preface, is "to provide material for a case study in educational administration, for an account of an experiment in novel methods of instruction, and for a record of exploration in the development of new ideas in a broad realm of human activity".

The opening chapter, covering the years 1898 to 1908, includes information on the development of the idea of a graduate business school at Harvard.

About one third of the book is devoted to a report on the administrative activities of the three outstanding deans who led the Harvard Business School to its present position of eminence. The story of the volume ends in 1955 with the retirement of Dean David. This emphasis on the activities of the three deans is not inappropriate for an informal history of a school dedicated to administration. Chapters are also included on the evolution of trends in concepts of instruction, the teaching and administrative organizations of the School, research, the method of instruction, the Master of Business Administration program, report writing, and the Business School library.

The fifty-odd pages given to the early years of the Business School are among the most interesting in the book. In the spring of 1908 when Gay was named Dean the school "consisted of an idea, not fully defined; pledges of $25,000 a year for five years, not fully subscribed; and an energetic new dean with no business experience and with few business acquaintances". There were "no courses, no organized teaching materials, no teachers trained in business administration, no students, and no plant". From this beginning Gay laid the groundwork and set the basic direction for the operation that is today world wide in importance and that has directly affected much of the thinking of and about businessmen in this country and abroad.

In the fall of 1918 enrollment had dropped to 18 first year students and 6 second year men and the school had partially disintegrated. After the Armistice a special session was arranged for veterans and the enrollment jumped to 127. In 1919, Wallace B. Donham became the second Dean of the Business School. Donham was a Harvard College and Harvard Law School graduate. He had served as assistant to President (then Professor) Lowell while in Law School. Called back to Harvard from a successful legal and business career, he served until 1942. Building on Gay's foundation he developed a professional institution with

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[1]Melvin T. Copeland, *And Mark an Era: the Story of the Harvard Business School.* Boston, Little, Brown and Company, 1958. pp. 368.

its own atmosphere and its own standards. The major accomplishment was probably the planning and conducting of the successful fund raising campaign which enabled the School to move into its present quarters across the Charles River in Boston. This story will intrigue any educator ever faced with fund raising. To quote one historic line delivered in 1924 by George Fisher Baker to Bishop Lawrence, chairman of the fund raising organization, "If . . . by giving five million dollars I could have the privilege of building the entire School, I should like to do it . . ." Harvard "let" Mr. Baker contribute the five million.

The major postwar developments included the establishment of several new programs. These were the Advanced Management Program, Middle Management Program, Trade Union Program, the Harvard-Radcliffe Program designed to train women for administrative positions, and the Doctoral Program. Dean David also had his fund raising successes. He was able to complete his program of raising $20,000,000 for the School. By the retirement of Dean David in 1955 enrollment had reached 1,689, the yearly expenses of the school had risen to over $4,000,000, and the plant had been enlarged and improved. The school was sound financially and its prestige was at an all time high.

The main objective of the author has been achieved. Copeland has contributed a broad case history of an intellectual adventure by a great university in a new field of education. Case studies do not usually have an index, bibliography or many footnotes. This book might have been even more useful if these items had been included. Some might question an overemphasis on the importance of the administrators at the expense of the faculty. Perhaps the author does minimize the intellectual and personal disagreements that must have characterized this complex educational institution over a fifty year period. But he does remind us that all concerned with business education and administration owe a debt of gratitude to the Harvard Business School. It contributed much to establishing the idea that business administration warranted and could be made a professional concern worthy of the study of university scholars and the practice of intelligent and thoughtful men. This was a startling concept in 1908. It apparently is doubted by some today. But any reader of this volume will have a clearer concept of the role played by the Harvard Business School in bringing the study and practice of business administration to its present position of importance.

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